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STUDENT PROJECT: THE DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT OF 1980

THIS ISSUE OF THE AKRON LAW REVIEW is devoted to legal questions relating to the savings and loan industry. This particular project consists of an in-depth examination of the very important piece of legislation named in the title above. Although many of the provisions contained therein directly impact upon savings and loans, the authors have not limited themselves to that aspect, but have also addressed issues relating to all types of depository institutions. A general discussion of interest regulation is given first. This is followed by a title by title, section by section analysis of the major provisions of this far-reaching act.

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INTRODUCTION: AN OVERVIEW OF INTEREST REGULATION

A. *Historical Perspective*

In the course of its history, Regulation Q¹ has served as a housing program, a banking industry stability program, and an indirect tax revenue measure. Regulation Q, in its basic form, establishes ceilings on the interest rates which various classes of depository institutions may pay to their depositors. The ceiling differential is used to compensate for variations in the regulatory restrictions pertaining to investments which can be made and services which can be offered. In the past decade, depositors have received less than the fair rental value of their money as market values for the use of the money rose with expectations of continued inflation.² Builders and buyers in the housing market benefited from a source of low interest financing subsidized in part by depositors. The mandated phaseout of Regulation Q under the Depository Institutions Deregulation and Monetary

¹ See Interest on Deposits, 12 C.F.R. § 217 (1980) (Federal Reserve System); 12 C.F.R. § 329 (1980) (Federal Deposit Insurance Corporation); and 12 C.F.R. § 526 (1980) (Federal Home Loan Bank Board) for maximum rates payable to their respective members. The popular name for such interest regulations has been Regulation Q. Some form has been in effect since January 1, 1936.

² *Regulation Q and Related Measures: Hearings on H.R. 4986 Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 96th Cong., 2d Sess. (1980) [hereinafter cited as 1980 House Reg. Q Hearings].

Control Act of 1980³ (hereinafter referred to as the 1980 Act) was the result of pressure from the small saver for an equitable return as well as pressure from an industry concerned about the outflow of deposits (disintermediation) from regulated depository institutions to alternative investments.

The foundations of Regulation Q date back to the Banking Act of 1933⁴ which authorized the Board of Governors of the Federal Reserve System to set ceilings on interest which member banks could pay on time deposits. Interest could not be paid on demand deposits.⁵ Interest rate ceilings for non-member banks were set by the Federal Deposit Insurance Corporation (FDIC).⁶ In the relative economic stability of the 1933 to 1966 time period, there was little pressure on the established ceilings. Market rates paid on savings deposits represented the rental value of money less the services provided to the saver. Thrift institutions and credit unions competed with banks for the depositors' savings. By enabling statutes and tax incentives, the thrift institutions concentrated in the home mortgage market and credit unions provided their members with consumer loans for automobiles and other non-residential purposes.

The delicate competitive balance among the regulated depository institutions was maintained by the Interagency Coordinating Committee (ICC). This informal group was comprised of the heads of the FDIC, Federal Reserve Board (FRB), FHLBB, National Credit Union Administration (NCUA), the Secretary of the Treasury and the Comptroller of the Currency.⁷ The ICC met regularly to discuss issues relating to the administration of Regulation Q, but did not take votes.⁸ Now, under Title II of the 1980 Act, the Depository Institution Deregulation Committee (DIDC) is comprised of the same representatives as the ICC had been. The Comptroller of the Currency is a member but has no vote. A majority vote is required for any action taken.⁹

During the 1970's, the average consumer price index annual increase was 7.42%¹⁰ and depository institutions faced disintermediation as savers

³ Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in scattered sections of 12, 15 U.S.C.) [hereinafter cited as 1980 Act].

⁴ See generally 12 U.S.C. § 227 (1976); see also 12 U.S.C. 371b (1976).

⁵ 12 U.S.C. § 371a (1976).

⁶ 12 U.S.C. §§ 1811, 1828(g) (1976).

⁷ 1980 *House Reg. Q. Hearings*, *supra* note 2, at 869-71 (testimony of Messrs. Sprague, Heimann, and Partee). Changes in the ceilings were determined by the FDIC, FHLBB, and the Federal Reserve.

⁸ *Id.* at 871.

⁹ 12 U.S.C.A. § 3502(b) (1980).

¹⁰ 1980 *House Reg. Q. Hearings*, *supra* note 2, at 910 (statement of the National Retired Teachers Association and the American Association of Retired Persons). Their chart compares the growing inflation of the 1970's with the relatively unresponsive passbook ceilings to emphasize the net negative interest to savers. See also MONTHLY LAB. REV., U.S. DEPT. OF LAB. BUREAU OF LAB. STATISTICS, Nov. 1980.

sought alternative markets such as government securities and Money Market Mutual Funds (MMMFS). The ICC reacted by giving institutions the authority to offer long term certificates of deposit (CD's) at market rates. The most successful of these CD's has been the six-month money market certificate introduced in June, 1978 which pays up to ½% above the twenty-six-week Treasury Bill rate.¹¹

The market rate CD's enabled depository institutions to slow the flow of deposits from their vaults but the CD's had various duration and minimum deposit requirements. Small savers and those having liquidity requirements continued to receive only nominal returns on their deposits. Those savers unwilling or unable to buy CD's were also kept out of the alternative markets to some extent by similar restrictions. Treasury Bills and other government securities were attractive where security was the prime objective but liquidity was limited, purchase was inconvenient, and minimums were high. MMMF's offered market interest rates and, in some cases, check-like withdrawals but were uninsured and the rate of return was not fixed in advance.¹² A third alternative which many savers found appealing was to spend money as it was earned, stocking up on necessities or purchasing retail goods before anticipated price increases. Because of the impact massive withdrawals by many small savers from the depository institutions would have, Congress and various presidential commissions gave careful study over the last decade to the desirability of continuing deposit interest rate ceilings.

B. *Presidential Initiatives on Deregulation*

In 1970 President Nixon appointed a Commission on Financial Structure and Regulation. The Commission, headed by Reed O. Hunt, was comprised of leaders in banking, government and industry. Their findings, commonly referred to as the Hunt Commission Report,¹³ contained the following interest ceiling recommendations: a) abolishment of interest ceilings for accounts of \$100,000 or more;¹⁴ b) stand-by authority to the Federal Reserve Board to stipulate ceilings on smaller accounts when serious disintermediation is threatened;¹⁵ c) discretionary power in the Board to reduce the \$100,000 cutoff amount for the stand-by power;¹⁶ d) stand-by power of the Board to establish interest rate ceilings including the power to establish differentials of limited duration between institutions providing

¹¹ Since their inception, the rates payable to purchasers of money market certificates have been generally in the 8 to 16% range. On January 1, 1981 the rate was 13.661%.

¹² See generally *Money Market Mutual Funds: Hearings Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking, Housing, and Urban Affairs*, 96th Cong., 2d Sess. (1980).

¹³ THE REPORT OF THE PRESIDENT'S COMMISSION ON FINANCIAL STRUCTURE AND REGULATION (1971) (Reed O. Hunt, Chairman).

¹⁴ *Id.* at 23.

¹⁵ *Id.*

¹⁶ *Id.*

third party payment services and those institutions not providing such services;¹⁷ e) five year limit on the authority to establish and maintain differentials;¹⁸ f) a ten year limit on the power of the Board to establish interest rate ceilings;¹⁹ and, g) retention of the prohibition against the payment of interest on demand deposits.²⁰ In addition, the Commission warned against piecemeal legislative action and stressed the interdependence of their recommendations.²¹ Other recommendations of the Commission dealt with: a) regulation of the functions of depository institutions;²² b) chartering and branching;²³ c) deposit reserve requirements;²⁴ d) taxation of financial institutions;²⁵ e) deposit insurance;²⁶ f) housing and mortgage markets;²⁷ g) regulation and supervision of financial institutions;²⁸ and h) other related matters.

In 1973 President Nixon, after considering the Hunt Commission recommendations, made the following proposals to Congress: a) interest ceilings on time and savings deposits should be removed over a 5½ year period; b) federally chartered thrift institutions and banks should be allowed to offer expanded deposit services for consumers; c) investment and lending alternatives for federally chartered thrift institutions and banks should be expanded; d) federal charters for stock savings and loan institutions and mutual savings banks should be permitted; e) credit unions should be provided with greater access to funds; f) Federal Housing Administration and Veterans Administration interest ceilings should be removed; and g) the tax structure of banks and thrift institutions be modified.²⁹

President Carter also recognized the need for reform of existing regulations. In 1978 he established the Inter-Agency Task Force on Deposit Interest Rate Controls and Housing Credit. The Task Force included representation from the Treasury Department, the Department of Housing and Urban Development, the Office of Management and Budget, the Council of Economic Advisors, the Office of the Special Assistant to the President for Consumer Affairs, the President's Domestic Policy Staff, the Federal

¹⁷ *Id.* at 23-24.

¹⁸ *Id.* at 24.

¹⁹ *Id.*

²⁰ *Id.* at 27.

²¹ *Id.* at 8-9.

²² *Id.* at 31.

²³ *Id.* at 59.

²⁴ *Id.* at 65.

²⁵ *Id.* at 71.

²⁶ *Id.* at 73.

²⁷ *Id.* at 77.

²⁸ *Id.* at 87.

²⁹ President's Message to Congress on Restructuring Financial Institutions, 1973 PUB. PAPERS 682 (Aug. 3, 1973), reprinted in DEPT. OF TREASURY, RECOMMENDATIONS FOR CHANGE IN THE U.S. FINANCIAL SYSTEM (1973).

Reserve, the Comptroller of the Currency, the FDIC, the FHLBB, and the NCUA.³⁰ The task force concluded that:

[T]he current deposit interest rate control system is not functioning as it was intended. First, it does not prevent disintermediation and the consequent curtailment of funds for housing finance. Second, it is unfair to small savers, who are deprived of the market rates of return available on a wide array of specialized or unregulated financial assets. Third, the current system of rate controls leads to inefficiencies in the financial marketplace.³¹

In his request for financial reform legislation³² President Carter made recommendations to Congress based on the Task Force findings. He recommended comprehensive financial reform regulation including provisions for an orderly transition to market-level interest rates to the average depositor and measures to protect the long-term viability of savings institutions. He specifically asked Congress to grant federally-chartered savings institutions authority to offer variable rate mortgages (VRM's) and to invest up to ten percent of their assets in consumer loans. In addition, Congress was asked to grant Negotiable Order of Withdrawal (NOW) account authority to federally-insured institutions.³³

Congressional action on the deregulation proposals has been selective and cautious, but not to the point of being unresponsive. The changes incorporated into the 1980 Act resulted from a careful balancing of conflicting interests among the depository institutions and their customers. The following section will explore some of the arguments made by some of the special interest groups at legislative hearings.

C. *Arguments For and Against Deposit Interest Ceilings*

Any form of government regulation will benefit one segment of society at the expense of another. In transportation regulation, the additional expense of serving rural communities is underwritten by urban customers. Public utilities are regulated to provide uniform service and to prevent monopolistic excesses. Two standards can be used to measure the degree to which some will benefit and some will lose under the regulations. The first is the situation which would exist in the total absence of regulations and mechanisms for regulation. The second is the status quo which existed just prior to changes in the regulatory balance. The second standard is particularly important where existing regulations have been in effect long enough for entities to act in reliance on the continued existence of the regulations.

³⁰ DEPT. OF TREASURY, DEPOSIT INTEREST RATE CEILINGS AND HOUSING CREDIT: THE REPORT OF THE PRESIDENT'S INTER-AGENCY TASK FORCE ON REGULATION Q (1979).

³¹ *Id.* at x.

³² President's Message to Congress Proposing Financial Reform Legislation, 1979 PUB. PAPERS 928 (May 22, 1979).

³³ *Id.* at 930.

The arguments presented during hearings on the removal of interest ceilings can be classified by the standard which was advocated. Those advocating a fair return or market-level interest on their deposits were making their arguments on the basis of the first standard.³⁴ Those arguing on behalf of the housing industry or prospective homebuyers or on behalf of depository institutions having long-term low interest mortgages in their portfolios were advancing the second standard.³⁵ In the many years of regulated interest rates, investment decisions were made in the expectation of continued subsidy of the mortgage industry by the government and small savers.

Some of the arguments advanced in favor of continued deposit interest rate ceilings were based on social policy objectives or economic stability considerations. The AFL-CIO advanced a convincing argument that small savers would not really benefit from increased interest paid on their deposits.³⁶ In its hypothetical situation, a family with \$1500 in a savings account spent \$15,000 during the year. It projected that the gain from increased interest on the savings would be more than offset by increased prices in consumer goods as producers and sellers passed on increased costs which they had to pay for borrowing. Some interesting counter-arguments can be made.

First, if the \$1500 saver is losing money, where is it going? In the example, the producers and sellers, by passing on their increased borrowing costs, may experience less demand for their products at the increased prices. Therefore at best, they break even. The non-saver will have to pay increased prices with no corresponding benefit. The large saver, or those willing to tie up their small savings for two and one-half years, will not benefit unless certificate of deposit ceilings are also lifted. The slowing or reversal of disintermediation is an advantage for the banks but it is offset by the higher interest which would be paid to the small saver. Therefore, if anyone is gaining at the expense of the \$1500 saver, it is other small savers with a higher ratio of savings to consumption. The saver in the AFL-CIO example had a savings to consumption ratio of one to ten. An example of a saver with a higher ratio (one to two) is one with \$5000 in savings and \$10,000 in annual expenses.

Second, the cost of consumer goods is not directly related to the interest paid to small savers. In 1980 the prime lending rate varied from twenty-percent in April to eleven percent in July and went back up over twenty percent in December. At the same time interest paid to small savers remained at nominal levels. The interest rate on loans is tied to the demand

³⁴ This group included the Grey Panthers, the Campaign for Economic Democracy, and the California Council for Older Americans. 1980 *House Reg. Q. Hearings*, *supra* note 2 at 685-86 (statement of Robert Gnaizda of Public Advocates, Inc.).

³⁵ This group included the AFL-CIO (*Id.* at 665) and the National Association of Homebuilders (*Id.* at 544).

³⁶ *Id.* at 678-79 (statement of H. Schechter, Director, Dept. of Urban Affairs, AFL-CIO).

for a limited number of dollars which depository institutions have to lend. Banks and other depository institutions would surely pass on increased interest costs but if market levels of interest were to be paid on small saver's accounts, then savers might deposit more of their spendable income, thereby increasing the dollars available to lend. The increased attractiveness of savings accounts would reduce the demand on consumer goods. That reduced demand would translate to reduced demand for business loans and reduced consumer prices (assuming that a free supply and demand market existed). It must be remembered that people will eventually spend some or all of their savings when they have more than they need for security or when buying an expensive item such as a car or house. Thus it is impossible to predict what effect increased passbook interest will have on consumer prices.

Third, the \$1500 passbook saver should not expect the same interest as a \$1500 certificate of deposit owner. There is a point at which a depository institution is expending more in servicing an account than it is making on the use of the deposits. Ideally, the interest paid on deposits should represent the value to the institution of the use of the money minus the cost of servicing the customer.

Some of the other arguments for a continuation of Regulation Q-type interest controls can be summarized as follows: a) banks will fail if they have to be competitive;³⁷ b) the housing industry will suffer from resulting higher lending rates;³⁸ c) older people who are losing money on their passbook accounts have purchased homes under low regulated interest conditions and thereby benefited from Regulation Q; d) the rich should not get richer;³⁹ e) home ownership is the "American dream."⁴⁰

All of these arguments advance regulation as a means to achieve social objectives through an indirect tax on the small saver. During the hearings, Representative Frank Annunzio said of Regulation Q:

It has been the singularly most successful housing program ever designed in this country. It has not cost the taxpayers a single penny, and there has not been a single scandal attached to it.⁴¹

Millions of small savers are taxpayers also and it has cost them plenty. Chairman St. Germain said that "the time has arrived where we have to say it is time for the borrower to pay the price of the money that they seek to borrow in order to pay a fair return to . . . the small account holders."⁴²

³⁷ *Id.* at 670-71.

³⁸ *Id.* at 548-57 (statement of the National Association of Homebuilders).

³⁹ *Id.* at 718, 726. Compare the testimony of Mr. Gnaizda on behalf of the Grey Panthers with the testimony of Mr. Schechter of the AFL-CIO on the referenced pages.

⁴⁰ *Id.* at 142 "[t]he American dream . . . is to own their own home with a white picket fence around it and rose bushes."

⁴¹ *Id.* at 12.

⁴² *Id.* at 255.

Perhaps Representative Doug Barnard summed up the mood of Congress when he said:

I think the chairman and most of this subcommittee agree that the sooner that we get out of being the goddess of justice, as far as the competition is concerned, the better off we will be, because we're never going to weigh those scales correctly. There is one proverb about this business: You can't make all the people happy all the time.⁴³

The 1980 Act was the culmination of years of studying, experimenting with, and refining the delicate balance of competition among the depository institutions. It reflects a blend of the recommendations of recent Presidents, the Hunt Commission, the Task Force, regulators, depository institutions, and special interest groups. Primarily, it provides a framework for regulation based on present social policy objectives with mechanisms included for continuous adjustment and fine tuning as the economic effects of the Act become manifest.

The following sections will explore the provisions of the 1980 Act in detail.

TITLE I: MONETARY CONTROL ACT OF 1980

A. Introduction

The decline in the Federal Reserve Membership has prompted the concern of the Federal Reserve and Congress.⁴⁴ This decline has been going on since World War II, but has accelerated in recent years (since 1970). The drop of membership has intensified in the three years (1978-1980) that Congress has debated the solution to membership attrition.⁴⁵ A further decline was expected in 1980 even though many institutions had deferred

⁴³ *Id.* at 256.

⁴⁴ From 1970 to 1978, 430 member banks withdrew from the system, while only 103 non-member banks have joined. As of the end of 1977 member banks held less than seventy-three percent of total commercial demand deposits, down eight percentage points since 1970. Thus, over one-fourth of commercial banks deposits and over three-fifths of all banks are outside the scope of Federal Reserve control. *Monetary Control and the Membership Problem: Hearings on H.R. 13476, H.R. 13477, H.R. 12706, and H.R. 14072, before the House Comm. on Banking, Finance, and Urban Affairs, 95th Cong., 2d Sess. 89, 90-1 (1978)* (Statement of G. William Miller, Chairman, Board of Governors of the Federal Reserve System) [Hereinafter cited as *Monetary Control Hearing of 1978*].

⁴⁵ From 1978 to the beginning of 1980, the proportion of all bank deposits held by member banks dropped three percent to a gross level of seventy percent. *Federal Reserve Requirements: Hearings on S.353 and Proposed Amendments S.85, and H.R.7, before the Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess. 8 (1980)* (statement of Paul Volcker, Chairman, Board of Governors of the Federal Reserve System.) [Hereinafter cited as *Federal Reserve Requirement Hearing of 1980*].

from withdrawing until Congress passed legislation.⁴⁶ Not only is the total number of banks within the system changing, the composition is also in flux. Most of the banks withdrawing from membership had been small (total deposits under \$50 million) but a developing trend has been for larger banks to leave the system.⁴⁷ Now larger institutions have decided the cost of membership in the Federal Reserve is too high a price because nonmembers may hold their required reserves in the form of interest bearing assets (as determined by state statute), and the development of NOW accounts (interest bearing checking accounts) at thrift institutions has sharpened the competition among depository institutions. Thus the decline in membership has been attributed to three factors:

- (1) The excessive cost of membership. Only member banks must retain all of the Federal reserve requirements in nonearning reserves.⁴⁸
- (2) The inequity of cost burden by member banks. Nonmembers and thrift institutions which compete in the same markets for loans and demand deposits are either exempt from reserve requirements or can maintain interest bearing reserves.⁴⁹
- (3) The increase in competition.⁵⁰ The commercial bank's past domain of offering demand deposits has been eroded by the entry of nonbank thrift institutions.⁵¹

A staff study of the House Committee on Banking, Finance, and Urban Affairs predicted a number of dire consequences due to the decline in membership.⁵² First, it has been proposed that the Federal Reserve's monetary control would be weakened because fewer banks within the Reserve means fewer banks can be influenced by changes in reserve requirements.⁵³ As more transaction accounts are held at nonmember institutions, the relationship between the money supply and reserve levels controlled by the Federal Reserve becomes less precise as a tool to implement policy and predict the result of monetary control. Secondly, the nation risks an increase in bank failures because nonmember banks during a period of tight monetary control may not have access to liquidated as-

⁴⁶ A 1979 survey by the Federal Reserve Board, concluded that 320 member banks were considering withdrawal from the Federal Reserve system and another 350 member banks were actively withdrawing. These 670 banks represented a possible decline of ten percent of the Federal Reserve membership and over seventy-one billion dollars in potential lost reserves. *Id.* at 9.

⁴⁷ *Id.*

⁴⁸ *Monetary Control Hearing of 1978, supra* note 44, at 91-92.

⁴⁹ *Id.* at 92-93.

⁵⁰ *Id.* at 93.

⁵¹ In New England, which has had NOW accounts before 1980, the Federal Reserve's share of member banks dropped from seventy-three percent to sixty-two percent during the period 1974 to 1977. *Id.*, at 91.

⁵² *Id.* at 524, 539-44.

⁵³ *Id.* at 539.

sets in order to meet their daily obligations.⁵⁴ The Federal Reserve only loans money to *member* banks through the discount window in order to cushion the impact of a transition from open to tight monetary policy. In comparison to nonmember correspondent banks the amount of credit the Federal Reserve may extend is not tied to profit but is determined by its monetary policy goals.⁵⁵ Therefore, in a liquidity crunch, nonmember banks may not have access to an adequate amount of loans correspondent banks consider their profit levels and the potential credit risks before extending any loan. Thirdly, the treasury loses a substantial amount of revenues because the Federal Reserve has fewer reserves to invest in interest earning government securities and therefore less interest income is transferred to the treasury each year.⁵⁶ Fourthly, the decline in membership adversely affects the prestige, strength, and autonomy of the Federal Reserve as an independent governmental institution.⁵⁷ With a decline in constituents, the Federal Reserve will have less political clout to carry-out unpopular but necessary monetary policy.

The Federal Reserve's emphasis on the importance of membership is not shared by all. Nonmember banks,⁵⁸ the U.S. League of Savings Association,⁵⁹ the National Savings and Loan League⁶⁰ members of Congress,⁶¹ and reputable economists⁶² do not correlate a decline in membership with lack of monetary control. This divergent group cites that the lack of control is due to inaccurate and outdated information as well as the nonuniform reserve rate for member banks.⁶³ Some have proposed that reserves are not necessary at all to control monetary policy because many European nations require minimal, if any, levels of reserves,⁶⁴ and because the Federal Reserve, historically, has used reserve requirements much less than open market operations as the chief tool of monetary control.⁶⁵ Even while conceding that reserve requirements are helpful, opponents contend that the Federal Reserve has adequate power to stop the exodus of banks from

⁵⁴ *Id.*

⁵⁵ BOARD OF GOVERNORS, THE FEDERAL RESERVE SYSTEM, 36 (6th ed. 1974); *see also*; *Monetary Control Hearing of 1978*, *supra* note 44, at 541.

⁵⁶ *Monetary Control Hearing of 1978*, *supra* note 44, at 541.

⁵⁷ *Id.* at 543-4.

⁵⁸ *Monetary Control: Hearings on H.R.7, before the House Comm. on Banking, Finance, and Urban Affairs*, 96th Con., 1st Sess. 372, 431, 485, 500, 751 (1979) [hereinafter cited as *Monetary Control Hearing of 1979*].

⁵⁹ *Id.* at 689, 691-694.

⁶⁰ *Id.* at 703, 704.

⁶¹ *Id.* at 485, 487.

⁶² *Id.* at 375, 517, 735, 762.

⁶³ *Id.* at 380-2, 490-1, 646.

⁶⁴ 125 CONG. REC. H6320-1 (daily ed. July 20, 1979) (remarks by Rep. Wylie).

⁶⁵ *Monetary Control Hearing of 1979*, *supra* note 58, at 500; 508 (statement by Perkins on behalf of the American Bankers Association).

the system.⁶⁶ The Federal Reserve could lower reserve requirements, lower the discount rate, change their monetary policy of high interest rates, and/or request Congress to pass legislation allowing the Federal Reserve to pay interest on the present non-interest-bearing reserves. Nor do opponents believe the stability of the banking community is jeopardized. These opponents emphasize that Federal Reserve membership is a prerequisite for banks to be involved in the correspondent business. Therefore, these member correspondent banks are able to use the discount window to handle the credit needs of its nonmember clientele.⁶⁷ If nonmember banks need access to the discount window then they should be given direct access without also requiring they post reserves with the Federal Reserve System.⁶⁸

The assertion that the decline in Federal Reserve membership is a problem rests on two presumed effects: lack of monetary control and instability in the banking community because fewer banks are bearing the burden of monetary control. The question is, did Congress merely accept these truisms and proceed to decide how to stem the decline rather than first look into whether the decline actually was a problem? Even assuming the existence of a problem, was universal reserve requirements on all transaction accounts at depository institutions the most viable solution? Finally, should the Federal Reserve System be given more power in order to affect monetary policy? This comment addresses the above basic questions inherent in any analysis of Title I, the Monetary Control Act of 1980.

B. *The History and Function of the Federal Reserve System*

A discussion of the structure and history of the Federal Reserve system is needed in order to understand the changes suggested by Title I of the Depository Deregulation Monetary Control Act of 1980.

1. History of the Banking System

The American Banking system has become known as a dual banking system, because its main feature is a concurrent federal and state chartering of commercial banks. The federal banks are under the supervision of the Comptroller of the Currency (United States Treasury) and the state-chartered banks are under the regulation of state agencies. Indeed, the American system is unique among the world's systems. Every other major developed nation has a highly concentrated structure⁶⁹ but membership in the American National Banking System is voluntary.⁷⁰ Banks are induced to join the

⁶⁶ 125 CONG. REC. H6322 (daily ed. July 20, 1979) (remarks by Rep. Paul).

⁶⁷ *Federal Reserve Membership: Hearings on Amendment No. 398 to S.85, S.353, and H.R. 7 before the Senate Comm. on Banking Housing, and Urban Affairs*, 96th Cong., 1st Sess. 102, 105 (1979) (statements of John E. Malarkey, State Bank Commissioner of Delaware-Conference of State Bank Supervisors).

⁶⁸ *Monetary Control Hearing of 1978*, *supra* note 44, at 543.

⁶⁹ 125 CONG. REC. H6320 (daily ed. July 20, 1979) (remarks by Rep. Wylie).

system by being offered services and benefits rather than a compulsory approach.⁷¹

The dual banking system did not always run smoothly. From the Revolution until the Civil War, the American economy was plagued by bank failures and tight credit.

This situation persisted for two reasons. First, banks were under limited regulation.⁷² Many banks maintained adequate reserves and were able to redeem notes for coin, but others issued notes without concern for problems of liquidity in a rush for profits.⁷³ Secondly, there was no way to extend the money supply in response to concentrated seasonal demands of a rural economy because there was no central bank from which correspondent banks could borrow.⁷⁴

Even though the American people were suspicious of concentrating power in a central banking system, by 1861 the banking situation had become intolerable.⁷⁵ There were constant demands on Congress to stabilize the economy. As the economy expanded from a rural society to an industrial nation, large swings in liquidity were experienced. The National Banking Act of 1864,⁷⁶ was enacted to prevent the overissuance of notes which had caused the liquidity problems of not enough cash to redeem bank notes. (Note, at this time checks were not widely used and notes were redeemable

⁷¹ The benefits of the Federal System include:

- (1) Access to the discount window. As a public bank, the Federal Reserve is not operated for a profit. Profit objectives have no effect on the amount of credit that can be extended. Credit levels are a function of liquidity needs and monetary policy objectives;
- (2) Use of the Federal Reserve facilities to collect and clear checks as well as transfer funds among correspondent banks;
- (3) Ability to obtain currency and coin services;
- (4) Ability to obtain security safekeeping services;
- (5) Intangible benefits and prestige.

However, certain disadvantages must be recognized. The prospective member has the following responsibilities:

- (1) To retain required levels of reserves which are noninterest bearing reserves (commonly called "sterile" reserves). (Note, the Monetary Control Act of 1980 extends reserve requirements to nonmember banks and thrift institutions. This will decrease the above negative impact);
- (2) To submit to federal examinations;
- (3) To abide by federal rules and regulations on banking;
- (4) To supply information pertaining to banking transactions. (Note, the Monetary Control Act of 1980 extends reporting requirements to nonmembers and thrift institutions. Again this may decrease the negative impact.);
- (5) To purchase stock in the Federal Reserve. *Id.* at H6320; *see also*, BOARD OF GOVERNORS: THE FEDERAL RESERVE SYSTEM, (6th ed., 1974), 20; 36.

⁷² DUSSENBERRY, MONEY AND CREDIT: IMPACT AND CONTROL, 23 (1964).

⁷³ *Id.*

⁷⁴ *Monetary Control Hearings of 1979, supra* note 58, at 512.

⁷⁵ DUSSENBERRY, *supra* note 72, at 23.

⁷⁶ The National Banking Act of 1864, ch. 106, 13 Stat. 99 (1864) (codified at 12 U.S.C. § 36).

in gold coins).⁷⁷ Thus, national banks were required to hold reserves in vault cash or as deposit accounts with a national bank in one of seventeen "redemption" cities.⁷⁸ For reserve purposes, the Act classified national banks by geography. Each geographical classification (central reserve city banks, reserve city banks, and country banks) had different levels of required reserves as well as different apportionments of reserves between vault cash and deposit at the redemption cities.⁷⁹

A major flaw of the National Banking system was its inability to meet the seasonal demands for credit.⁸⁰ The system provided no way to vary the supply of credit to meet fluctuating demands. Large concentrated amounts of currency were withdrawn in the spring during the planting season and in the fall when crops were purchased.⁸¹ Banks often were solvent but unable to convert their assets into cash. This instability of the banking system was further caused by the pyramiding of reserves between the geographical classifications.⁸² Pyramiding occurred because reserve balances of country banks were held in banks at reserve cities and these banks held their reserves in central city banks.⁸³ When country banks needed currency they could draw on these deposits because comptrollers allowed banks to let their reserves fall well below legal minimums without legal recourse.⁸⁴ However, if at the same time city banks needed currency, the banking system's reserves may have been depleted by the country banks. Inevitably, some banks would fail and this only increased the financial panic. From 1878 to 1907, bank failures, plummeting stock prices and the failure of business plagued the economy.⁸⁵ Such economic instability hampered the potential industrial growth of the nation.

After the financial panics of the nineteenth and early twentieth century, a National Monetary Commission was established.⁸⁶ The recommendations of this commission became the basis for reform legislation and the creation of the Federal Reserve System.

2. The Federal Reserve System and the Changing Role of Reserves

The United States set up a central bank in 1914, after the passage of the Federal Reserve Act in 1913.⁸⁷ Decentralization of Banking power

⁷⁷ Dussenberry, *supra* note 72, at 23.

⁷⁸ Phillips and Robertson, *Are Uniform Reserve Requirements Really Necessary?*, 91 *BANKING L.J.* 403, 407-9 (1974).

⁷⁹ *Id.* at 408.

⁸⁰ Dussenberry, *supra* note 72, at 25.

⁸¹ *Id.*

⁸² Phillips and Robertson, *supra* note 78, at 408.

⁸³ *Id.* at 409.

⁸⁴ Dussenberry, *supra* note 72, at 25.

⁸⁵ *Id.*

⁸⁶ *Id.* at 26.

⁸⁷ The Federal Reserve Act of 1913, ch. 6, 38 Stat. 251 (1913). For codification, see Historical Note at 12 U.S.C. § 225 (1976).

was maintained because the "central" bank became not one institution but twelve.⁸⁸ A twelve-bank system would be able to react to the special needs of each part of the country, but without forsaking control. Control would be retained because the major policies of the Federal Reserve Banks are not controlled by member banks. Policy decisions are made by officers appointed by the Board of Governors located in Washington.⁸⁹ Besides managing the twelve federal reserve banks, the Board of Governors oversee monetary policy.⁹⁰

The new legislation retained the dual banking system. National banks were required to become Federal Reserve members but state banks had the choice to become members or to retain their state charters.⁹¹ Under this new banking system, member banks had to deposit reserves at the Federal Reserve banks. By an amendment to the Federal Reserve Act in 1917,⁹² required reserves were to consist solely of deposits with the federal reserve banks.⁹³ This amendment also changed the function of reserves from that of preserving liquidity to a tool of monetary policy.⁹⁴ Therefore, required reserves held by the Federal Reserve banks could no longer be used to meet the daily liquidity requirements of the member banks.

While the Federal Reserve Act and the subsequent amendments changed the role of reserve requirements, the Act retained the National Banking Act's reserve structure⁹⁵ and the old classification of central reserve, reserve city, and country banks.⁹⁶ This complicated the setting of reserve requirements. Not only were reserve requirements based upon a certain percentage of a bank's demand deposits but the banks in each classification had a different reserve rate schedule.⁹⁷ To further complicate the problem, in 1935 the Board of Governors acquired the authority to vary required reserve ratios.⁹⁸ Taking the problem one step further, by 1960 banks were again allowed to count a part of vault cash as reserves.⁹⁹ A new wrinkle was added to the already complicated reserve system, the "lagged reserve requirements

⁸⁸ *Id.* at § 2 (codified at 12 U.S.C. § 222 (1976)).

⁸⁹ 12 U.S.C. § 248 (1976).

⁹⁰ *Id.*

⁹¹ Dussenberry, *supra* note 72, at 26.

⁹² Act of June 21, 1917, ch. 32, 40 Stat. 232 (1917) (codified at scattered sections of U.S.C. Title 12).

⁹³ 12 U.S.C. § 642 (1976).

⁹⁴ Phillips and Robertson, *supra* note 78, at 412.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ Reserve city banks had a thirteen percent reserve requirement; the reserve city banks had a ten percent ratio, and the country banks had a seven percent ratio. *See* Act of June 21, 1917, ch. 32, § 10, 40 Stat. 239 (1917) (codified at 12 U.S.C. § 462 (1976)).

⁹⁸ Banking Act of 1935, ch. 614, 49 Stat. 684 (1935). For codification, *see* Historic Note at 12 U.S.C. § 228 (1976). This act eliminated the need for an "emergency" before such action could be taken. (*see* 12 U.S.C. § 426).

⁹⁹ Phillips and Robertson, *supra* note 78, at 414.

computations," under which each member bank adjusted its levels of reserves once a week to meet its reserve rate.¹⁰⁰ At any time during the interim the bank could be below or above its reserve level. A few years after lagged reserve requirements were implemented, the reserve structure of member banks were changed from a geographical classification to a classification by bank size.¹⁰¹ This reserve structure continued until the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980¹⁰² which will be subsequently discussed.

Thus, the role of reserves changed from a function of preserving liquidity under the National Banking System to a function of monetary control under the Federal Reserve System. This metamorphosis of reserves was enhanced by two aspects of the Federal Reserve system. First, reserves were no longer needed to serve a liquidity function because Federal Reserve banks acquired insurance provided by the Federal Deposit Insurance Company.¹⁰³ Secondly, to meet liquidity needs at times other than during insolvency, the Federal Reserve created¹⁰⁴ the discount window. The discount window is a term used to describe the process wherein the federal reserve makes loans by crediting a bank's reserve deposit account.¹⁰⁵ Based upon the above, the Federal Reserve System insured the liquidity of its member banks, rather than the reserve requirements of each bank.

3. How the Federal Reserve Controls Monetary Policy.

The Federal Reserve uses three instruments to carry-out its monetary policy objectives:¹⁰⁶ the discount rate,¹⁰⁷ open-market operations,¹⁰⁸ and reserve requirements.¹⁰⁹

The discount rate is the rate of interest charged by a Federal Reserve bank on loans made to other banks. In return for the loan, the commercial bank may give as collateral IOU's drawn against themselves or the promissory notes of businesses and individuals which they hold as security against loans granted to the public. The discount rate is set by each Federal Reserve Bank's board of directors, subject to the approval of the Board of Governors of the Federal Reserve System.¹¹⁰

¹⁰⁰ *Id.* at 417.

¹⁰¹ *Id.* at 416.

¹⁰² 1980 Act, *supra* note 3.

¹⁰³ See 12 U.S.C. § 1811 et. seq.

¹⁰⁴ BOARD OF GOVERNORS, THE FEDERAL RESERVE SYSTEM 72 (6th ed. 1974) *see also*, Dussenberry, *supra* note 72, at 27.

¹⁰⁵ *Id.*

¹⁰⁶ McCONNELL, ECONOMICS: PRINCIPLES, PROBLEMS, AND POLICIES, 315-16.

¹⁰⁷ 12 U.S.C. § 357 (1976).

¹⁰⁸ 12 U.S.C. § 358 (1976).

¹⁰⁹ 12 U.S.C. § 462 (1976).

¹¹⁰ *Id.*

Borrowing money from the Federal Reserve affects the reserve position of a bank. If a bank borrows money from the Federal Reserve, the regional Federal Reserve Bank then credits the member bank's reserve account by the amount of the loan. Since a bank can loan only that amount of money in excess of its reserve requirements, a credit to its reserve account means it has more reserves which can support more loans. Therefore, when a commercial bank borrows from the federal reserve system, it can extend more credit to the public. Conversely, when a bank repays its loan, it has less money to loan to the public.

Banks, like all creditors, are more encouraged to borrow when the interest rate at the discount window (the discount rate) is low rather than high. Hence, a decrease in the discount rate encourages banks to pass the savings to the public in the form of lower interest rates. Conversely, an increase in the discount rate discourages banks from borrowing. Those banks which must borrow raise their interest rates in order to offset their increased costs.

From the Federal Reserve's viewpoint, the discount rate is a tool of monetary policy.¹¹¹ Varying the discount rate discourages or encourages the public to increase the money supply by borrowing from commercial banks. Thus by raising or lowering the discount rate the Federal Reserve system can meet its monetary goals.

It must be noted, the discount rate is a weak monetary tool. Banks infrequently borrow from the Federal Reserve because they have to pay interest on their loans.¹¹² More importantly, banks view the need to borrow from the Federal Reserve as a black-mark against the bank's reputation.¹¹³ The Federal Reserve has encouraged this viewpoint because access to the discount window has been restricted.¹¹⁴ Basically, the Federal Reserve uses the discount window only to rescue a bank faced with a sudden cash shortage which can not be solved by any other means without jeopardizing the long-range solvency of the bank.¹¹⁵ Since credit has been extended only as a last resort, the use of the discount window has negative connotations.

The second tool of the Federal Reserve to control monetary policy is the manipulation of the reserve ratio. An example from an economic text book will concisely explain how reserve ratios influence the money supply:

Suppose a commercial bank's balance sheet is such that reserves are \$5,000 and demand deposits \$20,000. If the legal reserve ratios stands at 20 percent, the bank's required reserves are \$4,000. Since

¹¹¹ *Id.*

¹¹² FUSFELD, *ECONOMICS*, 302 (1972).

¹¹³ *Id.*

¹¹⁴ *Id.* at 303.

¹¹⁵ MCCONNELL, *supra* note 106, at 316; FUSFELD, *supra* note 112, at 303.

the actual reserves are \$5,000, it is apparent that the excess reserves of this bank are \$1,000. On the basis of this \$1,000 of excess reserves we have seen that a single bank can lend \$1,000, but the banking system as a whole could create a maximum of \$5,000 in new bank money by lending.¹¹⁶

As the above example explains, the banking system can expand or contract the money supply by changing the reserve ratio. This method of controlling the money supply is similar to the discount ratio as previously discussed. If a decrease in the money supply is the goal, a higher reserve ratio increases the amount of reserves a bank must keep.¹¹⁷ Since a commercial bank can only lend an amount equal to its excess reserves, any excess reserves are transformed into required reserves in order to meet the new reserve ratio.¹¹⁸ Depending on how much the reserve ratio is increased, a bank may be able to meet the new requirement by not extending new credit and by cutting costs. However, the bank's present level of reserves may not be enough to support its outstanding demand deposits. In that event, the bank would have to contract its money supply by calling in short term loans and by not renewing old loans.¹¹⁹

It must be noted that changes in reserve requirements have a great effect on the reserve positions of the member banks. For example, "when reserve requirements were raised by only one-half of one percent in December, 1967 (and even then on only demand deposits of over \$5 million) the total increase in required reserves was about \$550 million."¹²⁰ This impact of changes in reserve requirements would not be evenly felt throughout the banking or financial community. First, small businesses which are usually short of working capital may be harmed more than large businesses with excess profit margins. Secondly, small banks may not have the ability to juggle their resources in order to meet increased reserve requirements. For whatever reasons, the Federal Reserve has sparingly used reserve requirements as a tool of monetary policy.¹²¹ Therefore, its potential as an effective monetary tool is largely theoretical.

The Board of Governors primarily controls the money supply through open-market operations;¹²² that is, the buying and selling of government securities. For example, when the Federal Reserve buys securities it pays for them by crediting the reserve account of the purchaser, the commercial bank. This transaction increases member bank reserves which subsequently

¹¹⁶ McCONNELL, *supra* note 106, at 311.

¹¹⁷ *Id.* at 312.

¹¹⁸ *Id.* at 300.

¹¹⁹ *Id.* at 311.

¹²⁰ FUSFELD, *supra* note 112, at 300.

¹²¹ McCONNELL, *supra* note 106, at 312.

¹²² *Id.* Published by IdeaExchange@UAkron, 1981

increases the lending ability of the commercial banking system. Conversely, a sale of government securities reduces a bank's reserve account and its ability to extend credit.

The open market operations method is relied upon more than any other tool for basically three reasons. First, the effect of the open market operation on reserve balances is under the control of the Federal Reserve whereas the effect of the discount window depends on member banks borrowing at the discount window.¹²³ Second, changing market demands can be more effectively met by buying or selling securities rather than by lowering or raising reserve ratios.¹²⁴ Third, the Federal Reserve Banks have large holdings of government bonds the sale of which could reduce commercial bank reserves to zero.¹²⁵ Regardless of the tool chosen, the discount rate, the reserve ratios, or open market operations, effective monetary policy depends upon the ability of the Federal Reserve to decrease or expand the money supply.

C. *Background of the Monetary Control Act of 1980.*

1. Legislative History of Title I

The background of this legislation can be traced to 1950. The concept of treating all banks equally whether a member or nonmember of the Federal Reserve System was initiated by Senator Douglas in a report of a Congressional Committee in 1950.¹²⁶ It was "repeated in a 1952 report of a Congressional Committee, endorsed by the Commission on Money and Credit in 1961, reaffirmed by the President's Committee on Financial Institutions in 1963, and restated again in the 1971 report of the President's Commission on Financial Structure and Regulation."¹²⁷ However, it was not until 1977 that Congress seriously tried to overhaul the nation's banking system.

In 1977, the Senate Banking Committee reported out a bill which would have authorized the Federal Reserve Board to equalize competition between nonmembers and members by paying interest on reserve requirements of member banks.¹²⁸ However, this bill did not even come to a vote on the Senate floor.¹²⁹

Again, in 1978, legislation was introduced in the House which was

¹²³ *Monetary Control Hearings of 1979*, *supra* note 58, at 508.

¹²⁴ *Id.*

¹²⁵ McCONNELL, *supra* note 106, at 319.

¹²⁶ See H.R. REP. No. 96-263, 96th Cong., 2d Sess. 8 (1979).

¹²⁷ *Id.*

¹²⁸ S. 2055, 95th Cong., 1st Sess. (1977); S. REP. No. 95-407, 95th Cong., 1st Sess. (1977); see 33 Cong. Q. Almanac 152-153 (1977).

¹²⁹ *Id.* at 152.

designed to halt the exodus of members from the Federal Reserve System.¹³⁰ After the Committee on Banking, Finance, and Urban Affairs of the House of Representatives held hearings on these bills, a clean bill, H.R. 14072, was reported to the House.¹³¹ H.R. 14072 was the forerunner of the present Monetary Control Act because it required all major federally insured banks to maintain reserves; a mandatory rather than a voluntary approach. Opponents of the bill, especially smaller and medium-sized banks, contended that such an action would destroy the dual banking system.¹³²

Despite pressure from the Federal Reserve Board to enact the bill, the House did not take further action after it became apparent the Senate would not have time to act until the next session in 1979.¹³³

The unfinished business of the 95th Congress, the problem of declining Federal Reserve membership, was thrust upon the 96th Congress. In January, Henry Reuss introduced a bill, H.R. 7, which was referred to his House Banking, Finance & Urban Affairs Committee.¹³⁴ The original H.R. 7 would have required all banks to hold reserves equal to 9.5 percent of all demand deposits in excess of fifty million dollars and authorized a reserve ratio variation between 8 and 10 percent.¹³⁵ The approach to H.R. 7, to stop the erosion of membership from the system, was similar to H.R. 14072 of 1978. Both bills endorsed mandatory reserve requirements for nonmember banks and thrift institutions which had traditionally been exempt from holding reserves with the Federal Reserve banks.

The opponents of the bill preferred a Republican substitute offered by Rep. Stanton (R-Ohio) which favored voluntary reserve requirements rather than mandatory ones.¹³⁶ A voluntary system would use the inducements of lower reserve requirements, interest on reserve requirements, and freer access to the discount window. Only when reserves sank below 66 percent would Stanton's substitute bill call for mandatory universal reserve requirements.¹³⁷

Chairman Reuss was a proponent of universal reserve requirements,

¹³⁰ A number of bills to deal with the problem were introduced in the House, namely H.R. 13476, 95th Cong., 2d Sess. (1978); H.R. 13477, 95th Cong., 2d Sess. (1978); H.R. 12076, 95th Cong., 2d Sess. (1978); See *Monetary Control Hearings of 1978*, *supra* note 44, at 2, 11, and 13 respectively.

¹³¹ H.R. 14072 incorporated parts of previous bills but it streamlined and combined the various proposals. H.R. 14072, 95th Cong., 2d Sess. (1978); *Monetary Control Hearings of 1978*, *supra* note 44, at 509; see also 34 Cong. Q. Almanac 271 (1978).

¹³² See *Monetary Control Hearings of 1978*, *supra* note 44, at 693, 700 (Statement of Lewis R. Holding).

¹³³ 34 Cong. Q. Almanac 271 (1978).

¹³⁴ H.R. 7, 96th Cong., 1st Sess., (1979) *Monetary Control Hearings of 1979*, *supra* note 58, at 2.

¹³⁵ *Id.* at 10.

¹³⁶ See H.R. REP. 96-263, 96th Cong., 1st Sess. (1979).

¹³⁷ *Id.* at 37.

and thus was ideologically opposed to this type of proposal, so it was a surprise when the House passed H.R. 7 on July 20, 1979 as amended by Representative Stanton.¹³⁸ Chairman Reuss supported the compromise in order to send a bill to the Senate which had the overwhelming support of the House. The House in September also passed H.R. 4986, the Consumer Checking Account Equity Act of 1979 and likewise sent this to the Senate.¹³⁹

In the interim, the Senate had begun work on its own Federal Reserve membership legislation. The Senate Banking Chairman Proxmire, D-Wis., supported universal reserve requirements while Senator Tower, R-Texas, endorsed a voluntary system.¹⁴⁰ Both Senators were appointed to the Senate Conference Committee.

The Tower Bill (S. 353), a voluntary system, endorsed interest payment on reserve requirements and reduced reserve requirements.¹⁴¹ In comparison, Proxmire's Bill (S. 85) required universal reserve requirements on all banks. Unlike the House version, no exemption level was endorsed, but there was a three percent reserve requirement on the first five million of demand deposits and twelve percent on the remainder above that amount.¹⁴²

However, the Senate did not incorporate any membership proposal in its version of H.R. 4986. Senator Morgan (D-N.C.), succeeded in stripping the bill of a provision which would make universal reserves mandatory for all banks that offered NOW accounts.¹⁴³ Both Houses of Congress met in conference to reconcile the two versions of H.R. 4986.

The conference reached an impasse on December 5, because the conflicting proposals were the pet projects of the respective chairmen. The House provision on the membership problem, as touted by Chairman Reuss, was absent in the Senate version, while the Senate provision which phased out interest rate limits was absent in the House version. The conferees, unable to reach agreement on these key issues, deferred further action on H.R. 4986 until 1980.¹⁴⁴

When the House and Senate Banking Conferees resumed work, they faced a time constraint. A decision had to be reached by March 31, 1980 because stopgap legislation, which protected interest bearing checking ac-

¹³⁸ *Federal Reserve Membership. Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 96th Cong., 1st Sess. 72. The bill as passed not only incorporated the Stanton cutoff, 67.5% (*Id.* at 87) but also set the exemption level at thirty-five million (*Id.* at 78).

¹³⁹ 1980 *House Reg. Q. Hearings*, *supra* note 2, at 4.

¹⁴⁰ S. 85, 96th Cong., 2d Sess. (1980) *Federal Reserve Requirements Hearings of 1980*, *supra* note 45, at 167 (introduced by Sen. Proxmire) and S. 353, 96th Cong., 2d Sess. (1980), *Id.* at 149 (introduced by Sen. Tower).

¹⁴¹ *Id.* at 153.

¹⁴² *Id.* at 171.

¹⁴³ 35 Cong. Q. Almanac 323 (1979).

¹⁴⁴ *Id.* at 324.

counts from a court ordered ban, expired on that date.¹⁴⁵ To further complicate the situation, both the House and the Senate conferees were bargaining without clear directions from their committees. Neither Committee could reach a consensus on the issues in conflict - the membership problem and the phaseout of "Regulation Q". Due to the intensified pressure of the ominously close stopgap legislation deadline, a hastily put together version of H.R. 4986 was signed into law on March 31, 1980.¹⁴⁶

2. Provisions of Title I

The Monetary Control Act of 1980 has greatly changed the system of reserve requirements and reporting requirements of depository institutions in the following areas:

a. Reporting requirements.

Section 102 of the Act¹⁴⁷ authorizes the Federal Reserve to collect, through regulatory and supervisory agencies, current liability and asset reports from depository institutions (banks, savings banks, savings and loans, and credit unions). The Federal Reserve has full discretion to determine the type and frequency of the reporting requirement. These reports are deemed necessary in order to monitor and control the money supply. Prior to section 102, only member banks were required to provide relevant data.

b. Reserve Requirements

This part of the Act¹⁴⁸ subjects all financial institutions to reserve requirements on transaction accounts (accounts which are third-party payments such as demand deposits, NOW accounts, telephone transfers, and share drafts)¹⁴⁹ and non-personal time deposits (transferable time deposits or deposits not held by an individual).¹⁵⁰ Thus, a mandatory reserve system replaced the voluntary system. The uniformly imposed reserve requirement structure is:

- (1) a reserve ratio of three percent on the first twenty-five million dollars of transaction account deposits.¹⁵¹
- (2) an increased reserve ratio of twelve percent for transaction accounts in excess of twenty-five million dollars.¹⁵²
- (3) a possible variation in the reserve ratios between eight and fourteen percent for that portion of transaction accounts in excess of twenty-five million dollars.¹⁵³

¹⁴⁵ See 1980 House Reg. Q. Hearings, *supra* note 2, at 1.

¹⁴⁶ 1980 Act, *supra* note 3.

¹⁴⁷ *Id.*, § 102 (to be codified at 12 U.S.C. § 248(a)(2)).

¹⁴⁸ *Id.*, § 103.

¹⁴⁹ *Id.* (to be codified at 12 U.S.C. § 461(b)(2)).

¹⁵⁰ *Id.* (to be codified at 12 U.S.C. § 461(b)(1)(c)).

¹⁵¹ *Id.* (to be codified at 12 U.S.C. § 461(b)(2)(A)(C)).

¹⁵² *Id.* (to be codified at 12 U.S.C. § 461(b)(2)(A)(ii)).

¹⁵³ *Id.*

- (4) a reserve ratio of three percent or a variable within a zero to nine percentage range on nonpersonal time deposits.¹⁵⁴

Beginning in 1981, the Board of Governors shall index the twenty-five million dollar breakpoint on transaction accounts by issuing a regulation which would increase or decrease the breakpoint by eight percent of the percentage increase or decrease in transactions accounts of all depository institutions.¹⁵⁵ Thus, by indexing the twenty-five million dollar breakpoint the banks which presently have a three percent reserve ratio will not be forced into the twelve percent reserve ratio by inflation. Therefore a bank must grow faster relative to the higher reserve ratio banks before it will exceed the breakpoint.

c. Waiver of Ratio Limits in Extraordinary Circumstances

This Act empowers the Board of Governors to impose reserve requirements outside the limitations prescribed in section 103 for a period of 180 days.¹⁵⁶ Such action can not occur unless five members of the Board determine that there is an extraordinary circumstance which requires waiving the set limits on reserve ratios. The Federal Reserve's power to vary reserve ratios may be extended for 180 day periods upon the action of five Board members.¹⁵⁷ Also, the above action is within the full discretion of the Board and is not reviewable by Congress.

d. Supplemental Reserves

Additional reserve requirements on depository institutions may be imposed up to a limit of four percentum of their transaction accounts.¹⁵⁸ This additional power referred to as "supplemental reserves" has certain restraints. First, the supplemental reserve may not be enacted unless it is essential for the conduct of monetary policy.¹⁵⁹ Secondly, such a requirement can not be imposed to reduce the cost burdens of reserve ratios or to increase the balances needed for check-clearing purposes.¹⁶⁰ Thirdly, supplemental reserves can not be imposed if reserve ratios are below the initial reserve ratio rates.¹⁶¹ Fourthly, the Board of Governors must send a report to Congress which states the basis for exercising such authority.¹⁶² Supplemental reserves, if imposed, are interest bearing at a rate not to exceed the average rate earned by the Federal Reserve's security portfolio during the

¹⁵⁴ *Id.* (to be codified at 12 U.S.C. § 461(b)(2)(B)).

¹⁵⁵ *Id.* (to be codified at 12 U.S.C. § 461(b)(2)(C)).

¹⁵⁶ *Id.* (to be codified at 12 U.S.C. § 461(b)(3)).

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* (to be codified at 12 U.S.C. § 461(b)(4)(A)).

¹⁵⁹ *Id.* (to be codified at 12 U.S.C. § 461(b)(4)(A)(i)).

¹⁶⁰ *Id.* (to be codified at 12 U.S.C. § 461(b)(4)(A)(ii)(iii)).

¹⁶¹ *Id.* (to be codified at 12 U.S.C. § 461(b)(4)(A)(iv)).

¹⁶² *Id.* (to be codified at 12 U.S.C. § 461(b)(4)(B)).

previous year.¹⁶³ Furthermore, supplemental reserves terminate at the close of the first ninety-day period during which the average amount of basic reserves is less than the amount that would be required if the initial ratios on basic reserves were in effect.¹⁶⁴

One of the most important provisions of the Act is section 103(7) which helps to offset the costs of universal reserve requirements.¹⁶⁵ Now, any depository institution in which transaction accounts or nonpersonal time deposits are held is entitled to the same discount and borrowing privileges as member banks. Prior to the enactment of this section, only member banks could procure the services of the Federal Reserve including the use of the discount window.

Another provision which helps to offset the cost of imposed reserve requirements is the change in the form of reserves.¹⁶⁶ Under the present Act, reserve requirements are met by maintaining vault cash or reserves at the federal reserve banks. These required reserves may be passed to the Federal Reserve banks through a correspondent bank, a federal home loan bank, or a central liquidity facility. Also the reserve requirement burden is lessened because the balances maintained to satisfy liquidity requirements may be used to satisfy other liquidity requirements imposed by state or federal law.¹⁶⁷

e. Pricing of Services and Effective Date

Besides imposing mandatory reserve requirements, this Act breaks the tradition of the Federal Reserve providing free services.¹⁶⁸ Although, all depository institutions have access to the Federal Reserve's services, these institutions will have to pay for any services procured. The Board of Governors by the sixth month after the bill's enactment is to publish a fee schedule. The schedule of fees shall cover the following services:

- (1) currency and coin services
- (2) check clearing and collection services
- (3) wire transfer services
- (4) automatic clearinghouse services
- (5) settlement services
- (6) security safekeeping services
- (7) Federal Reserve float
- (8) any new services offered in the future¹⁶⁹

¹⁶³ *Id.* (to be codified at 12 U.S.C. § 461(b)(4)(C)).

¹⁶⁴ *Id.* (to be codified at 12 U.S.C. § 461(b)(4)(E)).

¹⁶⁵ *Id.* (to be codified at 12 U.S.C. § 461(b)(7)).

¹⁶⁶ *Id.*, § 104 (to be codified at 12 U.S.C. § 461(c)(2)).

¹⁶⁷ *Id.*, § 104(a) (to be codified at 12 U.S.C. § 248(a)).

¹⁶⁸ *Id.*, § 107 (to be codified at 12 U.S.C. § 248a(b)).

¹⁶⁹ *Id.* (to be codified at 12 U.S.C. § 248a(b)).

This title of the Act shall take effect on the first day of the sixth month after its enactment.¹⁷⁰

3. Effects of Title I

The above provisions have numerous effects upon the banking system. One effect is to give the Federal Reserve 15.9 billion dollars in reserves without the supplemental, and a high of 27.1 billion with the supplemental.¹⁷¹ In comparison, the level of reserves before the Act was 31 billion. The second effect is to equalize the burden on member banks by reducing their reserve requirements and spreading the burden among the competing institutions. The third effect is that 4,165 nonmember banks, 1,360 savings and loans, and 70 mutual banks which previously were untouched by Federal regulation will have to post reserves at Federal Reserve banks.¹⁷²

Besides imposing uniform reserve requirements on all depository institutions, the legislative intent is to stabilize the financial system.¹⁷³ The Act relies on a number of devices in order to enhance financial stability. A potentially major device to ensure the system's liquidity is increased access to the discount window. Under this Act, all depository institutions, not just member banks, may borrow from the Federal Reserve. Additionally, the Federal Reserve's ability to predict and impose monetary policy is to be enhanced by two devices. One, the reserve ratio requirements for various types of depository institutions have been simplified in comparison to the prior classification scheme. Second, mandatory reports from all depository institutions will provide better access to information about the current money supply and future trends. Furthermore, the Act purports to make the Federal Reserve more efficient and economical because there is a charge for services procured by the depository institutions.¹⁷⁴ Prior to the Act, services were rendered to only member banks and without charge in order to offset the cost of posting reserves with the Federal Reserve banks. The adverse impact on member banks from having to pay for services is decreased because their reserve requirements have been lowered.¹⁷⁵ Whether or not the Act will live up to its legislative intent will be discussed in a subsequent section.

D. *Analysis of the Federal Reserve Membership Problem and the Ramifications of Title I as the Solution*

1. Is There a Federal Reserve Membership Problem?

The chairman of the Federal Reserve Board contends that the nation's

¹⁷⁰ *Id.*, § 108. Therefore, the effective date was October 1, 1980.

¹⁷¹ 125 CONG. REC. H2043 (daily ed. March 20, 1980).

¹⁷² *Id.* at H2044.

¹⁷³ 126 CONG. REC. H2274 (daily ed. March 27, 1980).

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

banking system will be weakened if membership in the Federal Reserve continues to decline.¹⁷⁶ A decline in membership means the Federal Reserve has less deposits subject to its reserve requirements and therefore less control over the money supply.

However, this premise is based upon the theory that reserve requirements are a necessary tool to control monetary policy.¹⁷⁷ Chairman Miller explains this necessity by asserting that as a larger portion of banks become subject to the diverse state reserve requirements, and as more transaction accounts are held by thrift institutions, the linkage between reserves and the money supply becomes less precise.¹⁷⁸

Another proponent of uniform reserve requirements is the President of the Federal Reserve Bank of New York.¹⁷⁹ In 1974, Mr. Waage presented the following argument in support of uniform reserve requirements:

Effective management of the supply of money and credit requires that the assets held as reserve by the banking system come under the control of the Federal Reserve. The reserve requirements of the states, regardless of what their role may be in protecting liquidity, do not meet this test. This defect is a serious one.¹⁸⁰

His article proceeds to explain why the "defect" is serious. It was claimed that member banks must support nonmember correspondent bank balances with reserves which are small in comparison to the nonmember's total deposits.¹⁸¹ The author gives an example to explain why it is inequitable to make only member banks bear the costs of monetary policy. In essence, member banks must hold one dollar in reserves to support seven dollars of demand deposits. In comparison, that same dollar in reserves at the member bank can support seven dollars of demand deposits for a nonmember bank, which in turn can use this same reserve to back-up fifty dollars of demand deposits.¹⁸² As a result, the quantity of all commercial bank deposits that can be supported by a given amount of reserves is altered by the movement of demand deposits between member and nonmember banks. The direct result of the movement of demand deposits between institutions with varying reserve ratios is to make the link between bank reserves and the money supply unpredictable.¹⁸³ Such an inability to predict the money supply causes the Federal Reserve to have less control over the economy.

¹⁷⁶ *Monetary Control Hearings of 1979*, *supra* note 58, at 70, 71. (Statement of G. William Miller).

¹⁷⁷ 65 FED. RES. BULL. 113 (1979) (Statements to Congress by G. William Miller).

¹⁷⁸ *Monetary Control Hearings of 1979*, *supra* note 58, at 72.

¹⁷⁹ Waage, *The Need for Uniform Reserve Requirements*, 91 BANK L.J. 499 (1974).

¹⁸⁰ *Id.* at 506.

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ *Id.* at 507.

However, it should be pointed out the Federal Reserve has never done a scholarly work which conclusively proves that the monetary control is weakened by the erosion of membership.¹⁸⁴ One might wonder why one of the largest employers of economists had not presented scholarly work to support their assertions during the debate of the Monetary Control Act. In turn, the premise that reserve requirements affect monetary policy has been contradicted by scholarly research.¹⁸⁵

Opponents of uniform reserve requirements purport that the Federal Reserve could control monetary aggregates without relying on reserves as a monetary tool.¹⁸⁶ Rather, the Federal Reserve could rely on two other tools, the discount window and open market operations in order to control the economy. These traditional tools will be improved because of the requirement, that all depository institutions report all assets and liabilities. This argument is bolstered by the fact that the Federal Reserve has traditionally relied upon open market operations rather than reserve requirements as a monetary tool.¹⁸⁷ The advantages of this tool are its predictable effect upon the money supply and its flexible implementation. To increase or decrease the money supply the Federal Reserve buys or sells securities on the open market rather than clumsily change reserve ratios of depository institutions.

A noted economist states another reason why reserve requirements are not a necessary tool of monetary policy.¹⁸⁸ Even if reserve requirements were reduced to zero, cash reserve would be maintained by banks regardless of any mandatory reserve level.¹⁸⁹ A study of state banks in Illinois, which does not have reserve requirements, shows that these banks maintained about five percent of their demand deposits in reserves.¹⁹⁰ All banks must retain a certain level of reserves in order to meet their check clearing needs and to pay for services procured from correspondent banks.¹⁹¹ This cash reserve base could be controlled by the Federal Reserve as long as it had adequate information concerning the levels of demand deposits at each bank. The Federal Reserve could then control this preexistent reserve base through the purchase and sale of government securities in the open market.

Also, a zero reserve requirement would benefit those banks whose

¹⁸⁴ *Monetary Control Hearings of 1979*, *supra* note 58 at 689, 692-3 (Statement of the U.S. League of Savings Associations). See *however, id.* at 762, 768-9 (Statement of Professor Whitesell) wherein it is stated that there has been one such study.

¹⁸⁵ *Id.* at 693, citing to Carson, *fn.* 146, *infra*, and others.

¹⁸⁶ *Id.* at 500, 515-6 (statement on behalf of the American Bankers Assoc.).

¹⁸⁷ *Id.* at 508.

¹⁸⁸ Carson, *Should Reserve Requirements be Abolished?* in *MONEY AND FINANCE*, 233 (2d ed. 1972).

¹⁸⁹ *Id.* at 236.

¹⁹⁰ *Id.* at 236 n.7.

¹⁹¹ *Id.* at 236.

present reserve levels have exceeded the balance they desire to hold.¹⁹² These freed reserves could be used to make loans or investments at the market interest rate. Such a zero reserve requirement, although benefiting the individual bank, would not negatively affect monetary policy. The Federal Reserve's open market operations might be used more frequently in order to prevent wide swings in the ratio of cash to deposits initially caused by a zero reserve requirement. Also, better reporting on cash reserve bases would minimize any remaining problems.¹⁹³ Actually, a zero reserve requirement would benefit the consumer. When reserves are freed, this increases the cash balances of banks which in turn can be used to meet the credit demands of consumers. Also, the consumer benefits because banking resources would be more efficiently allocated due to increased competition. Under a zero reserve requirement, the Federal Reserve would have to compete with correspondent banks for cash deposits because banks would be free to keep their balances at whichever financial institution paid the highest return. Thus, not only are reserve requirements a superfluous tool of monetary policy, but the economy would be improved if reserve requirements were reduced to zero.

The United States League of Savings Associations (the League) also disagrees with the use of uniform reserve requirements as a solution to the membership problem.¹⁹⁴ One of the main concerns of the League has been the lack of verification by the Federal Reserve that a decrease in membership directly affects monetary control.¹⁹⁵ The League acknowledges it has suffered from inflation caused by excessive growth in the money supply.¹⁹⁶ Nevertheless, the League contends that a movement from a voluntary system to a mandatory one is not the solution, especially since there is a lack of research to support the Federal Reserve's proposals.¹⁹⁷

In fact, the League asserts that the use of uniform reserve requirements as a monetary tool would be useless. The Federal Reserve has relied primarily on targeting interest rates by varying the federal fund rate daily or weekly in order to control monetary policy. This causes short-run fluctuations as a trade off for long-run stability.¹⁹⁸ Even if uniform reserves would blunt short-run fluctuations as the Federal Reserve claims, they are still valueless. As long as the Federal Reserve uses a monetary tool (controlling interest rates) which causes short-run fluctuations, implementing uniform reserves would be counterproductive. Furthermore, as the League points

¹⁹² *Id.* at 238.

¹⁹³ *Id.* at 236.

¹⁹⁴ *Monetary Control Hearings of 1979, supra* note 58, at 689 (statement of the U.S. League of Savings Associations).

¹⁹⁵ *Id.* at 692.

¹⁹⁶ *Id.* at 691.

¹⁹⁷ *Id.* at 692.

out, the real problem is long-run excesses in the money supply rather than daily fluctuations.¹⁹⁹

The League also opposed uniform reserve requirements because changing the reserve requirements has been an inefficient tool.²⁰⁰ Therefore, the League contends that open market operations is a superior tool with which to control monetary policy. In fact, the Federal Reserve has traditionally relied on this tool rather than varying reserves rates.²⁰¹ One of the main reasons open market operations has dominated as a monetary tool is that even when reserve ratios are varied, open market operations must be used to offset the initial effects on banking institutions.²⁰² A sudden increase in reserve ratios may result in a bank not having enough liquid assets to support an increase in reserves as well as to maintain its present level of financial activity.

A number of economists contend that there is not a membership problem as it has been defined; that is, as a lack of control over demand deposits which weakens the linkage between member bank reserves and the money supply. In fact, economist Greenbaum asserts that the use of uniform reserve requirement as a tool of monetary policy is the Federal Reserve's real problem.²⁰³ Uniform reserves are not an efficient monetary tool because variations in the reserve ratio add an additional variable in the money supply which is difficult to predict.

Greenbaum explains that, in theory, when Federal Reserve members leave the system, the effectiveness of the reserve requirement declines and variations in the money supply increase.²⁰⁴ However, other factors must be included in the 'real world' implementation of reserve requirements. Whenever reserve requirements are increased, financial institutions are induced to create substitutes for demand deposits, ones which do not have reserve requirements or have very low levels.²⁰⁵ Economist Greenbaum's argument was supported by examples of innovations created to avoid reserve requirements: NOW accounts, money market mutual funds, credit union share drafts, and repurchase agreements. By Greenbaum's analysis, as each of the above substitutes for demand deposits are required to bear reserves, innovative banking institutions will create new variations.

Besides the problem of substituting demand deposits for innovations which bear no little or reserve requirements, Greenbaum and a colleague,

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *Id.* at 693.

²⁰² *Id.* at 694.

²⁰³ *Monetary Control Hearings of 1979, supra* note 58, at 735. (statement of Prof. Stuart I. Greenbaum).

²⁰⁴ *Id.* at 736.

²⁰⁵ *Id.* at 737, <https://ideaexchange.uakron.edu/akronlawreview/vol14/iss3/4>

Professor Kanatas recommend that all legal reserve requirements be eliminated.²⁰⁶ In order to tighten the money supply, reserve requirements are increased. However, an increase in reserve requirements also increases the variability of the money supply, thus defeating effective monetary control. Therefore, Kanatas and Greenbaum assert that reserve requirements negatively affect monetary policy. A solution which they contend would moot the membership erosion problem would be to pay an interest rate on deposits voluntarily held at the Federal Reserve.²⁰⁷

To this commentator, the Federal Reserve's contention that reserve requirements are a necessary tool which must be protected by making reserves mandatory for all depository institutions is tenuous. In view of the fact Federal Reserve economists have published few, if any, scholarly studies in support of mandatory reserves, one can not help but question the necessity of the Monetary Control Act. If reserves are so valuable a tool that the voluntary system had to be forsaken for a mandatory system, one would expect some documentation. Adding to the confusion, reserve requirements have been touted as a necessary tool even though the Federal Reserve has traditionally relied on open market operations. Proponents of uniform reserve requirements attribute the lack of utilization of reserves to a fear of exacerbating federal reserve membership erosion. However, the Federal Reserve has relied primarily on open-market operations even before a "membership problem" had been asserted. If mandatory uniform reserve requirements are an absolute necessity how did the American banking system survive up until now? Before deciding how to solve a problem, it would seem more prudent to determine if there is a problem. Therefore, the question is, did Congress adequately analyze membership erosion in the Federal Reserve or did it start from the premise that the erosion was a problem?

2. Is Monetary Control Facilitated by Uniform Reserve Requirements?

The proponents of the Monetary Control Act contend that the shift of members to nonmember banks and the lack of control over thrift institutions has created problems in implementing monetary policy. The decreased control over reserves has been touted as the problem and uniform reserves for all depository institutions has become the chosen solution.

In comparison, there have been a number of studies which refute the notion that monetary control is facilitated by increasing the Federal Reserve's control over reserve requirements. Rather, these empirical studies demonstrate that the source of instability in the money supply has been caused by the graduated reserve requirement structure of member banks and not by the variation in reserve requirements between member banks and other banking institutions. According to these studies, the money supply

²⁰⁶ *Id.*

²⁰⁷ *Id.* at 742.
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could have been stabilized by streamlining the complex reserve structure of member banks. Thus, the Monetary Control Act did not need to extend reserve requirements to all depository institutions, but should have confined itself to streamlining the reserve structure of member banks.

The above conclusions are supported by Professors Robertson's and Phillips' 1974 article,²⁰⁸ Robertson and Phillips explain the factors which affect the ratio between the base money (net liabilities of the Federal Reserve) and the money supply (demand deposits plus currency). In order to accurately predict monetary policy, the Federal Reserve must compute how many dollars taken out of or placed in the money supply will generate a given level of economic activity. This multiple effect is referred to as the "multiplier". Predictability becomes difficult because the multiplier is made up of four ratios which have their own factors and parameters. A short description of each ratio is needed in order to be able to understand Phillips and Robertson's analysis:

- (1) *The R-ratio*. It is computed by dividing total reserves by total deposits. Prior to Title I, the Federal Reserve had to estimate the deposits held by nonmembers and thrift institutions.²⁰⁹
- (2) *The K-ratio*. This is the ratio of currency in the hands of the public to the total demand deposits. This ratio varies greatly because the public chooses to hold different levels of cash depending on seasonal or business cycles.²¹⁰
- (3) *The T-ratio*. Time deposits to demand deposits of all commercial banks. Under the Monetary Control Act, demand deposit reserve requirements differ from nonpersonal time deposits. The Federal Reserve must estimate the public's desire to hold time deposits in order to determine the effect on the money supply.²¹¹
- (4) *The G-ratio*. This is the United States governmental deposits in commercial banks to private demand deposits. Reserves are required on both deposits. A fluctuation in the amount of Government deposits held in the banking system affects the amount of private deposits held by the banking system.²¹²

The above ratios must be analyzed together to accurately predict and implement monetary policy. According to the Robertson and Phillips article, the R ratio is the least volatile of the other three ratios. Therefore, variations in the money supply are not caused by the movement of demand deposits between member and nonmember banks, as asserted by the Federal Reserve, but by a number of other variables affecting the money supply which are too numerous to accurately pinpoint the solution to uniform reserve

²⁰⁸ Phillips and Robertson, *supra* note 78.

²⁰⁹ *Id.* at 424.

²¹⁰ *Id.* at 424-5.

²¹¹ *Id.* at 425.

²¹² *Id.* at 425-426.

requirements. In contrast, these authors advocate relying on more predicable monetary tools such as open-market operations and requiring timely reports concerning banking institutions' assets and liabilities.²¹³

Another empirical study also demonstrates that non-member banks have not been a source of error or instability in monetary policy. One of the most thorough studies concerning this issue was published by Professor Starleaf in the 1975 *Journal of Finance*.²¹⁴ He contends that the variability in the deposit multiplier for all banks is less than the variability in the deposit multiplier for member banks. From this deduction, Starleaf inferred:

[A]ll of the tests indicate that the non-member banks have been a *moderate* source of stability for Federal Reserve control of the money stock . . . without non-member banks Federal Reserve control would have been slightly more unstable than it was in fact.²¹⁵

It must be noted Starleaf acknowledged that given the lack of precise data on nonmember bank activities his analysis may not be correct. However, the facts of his empirical analysis show that bringing non-member banks into a system of graduated reserve requirements would not reduce but would actually increase the instability or error in predicting monetary policy.

A rejoinder was published by Kopecky, an economist of the Federal Reserve System, in the 1978 *Journal of Finance*.²¹⁶ Kopecky challenges Starleaf's assertion that the Federal Reserve monetary policy would not be helped but would be negatively affected by uniform reserve requirements. In his rejoinder, Kopecky pursued a theoretical argument that the deposit multiplier for all commercial banks became more stable under universal reserve requirements. Without uniform reserves, the money supply becomes unpredictable because a proportion of deposits is in flux between member and nonmember banks and the total proportion of demand deposits subject to reserve requirements is decreasing.²¹⁷

In rebuttal, the American Bankers Association (ABA) submitted a memorandum to the House during hearings on the monetary control issue in 1979.²¹⁸ The ABA memorandum supported Starleaf's position and proposed unifying reserve ratio rates only within the member bank system. The author of the ABA memorandum attacks Kopecky's probability model because of a number of flaws.²¹⁹ Even once the flaws are corrected, the

²¹³ *Id.* at 430-2.

²¹⁴ Starleaf, *Nonmember Banks and Monetary Control*, 30 JOURNAL OF FINANCE 955 (Sept. 1975).

²¹⁵ *Id.* at 973-4.

²¹⁶ Kopecky, *Nonmember banks and Empirical Measures of the Variability of Reserves and Money: A Theoretical Appraisal*, 33 JOURNAL OF FINANCE 311 (March 1978).

²¹⁷ *Id.* at 314-317.

²¹⁸ *Monetary Control Hearings of 1979, supra* note 58, at 610 (memorandum from Charles Haywood representing the American Bankers Association).

²¹⁹ The ABA memorandum found three major flaws:

Kopecky model actually demonstrates a premise contrary to the one it seems to state. It actually premises that reserve ratios which vary among member banks, rather than between members and other institutions, have caused the error in predicting monetary policy. In conclusion, the ABA memorandum rejects mandatory reserve requirements and suggests that the solution to potential unpredictability is a better reporting system.²²⁰

It must be noted that this is the position of a 1979 article co-authored by economists of the Board of Governors of the Federal Reserve.²²¹ These economists state that the introduction in 1972 of graduated reserve requirements for member banks increased the variability of the reserve ratio on demand deposits.²²² Their empirical study shows that eighty-four percent of the additional variability in the reserve ratio since 1972 was due to the graduated reserve structure of member banks.²²³ Furthermore, this variance could be corrected by frequent and accurate reports on banking activity. Once reserve level fluctuations become predictable, open-market operations can be used to offset any undesired contractions or expansions in the money supply.²²⁴

As the above article exhibits, even economists within the Federal Reserve system are not in agreement on the necessity for uniform reserves. Assuming the studies against uniform reserve requirements are accurate, the Monetary Control Act of 1980 did not have to force nonmember banks and thrift institutions into holding noninterest-bearing reserves. A fairer and more viable solution would have been to abolish gradual reserve requirements within the membership system and to confine the Monetary Control Act to its reporting requirements.²²⁵ Again, this commentator questions whether there are adequate scholarly studies to warrant changing the banking system from voluntary to mandatory reserve requirements. If Congress can not obtain one of its main objects, greater monetary control, then Title I will have been a costly but useless adventure for those institutions previously exempt from federal reserve requirements.

This commentator questions the legislative intent in passing the Mone-

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- (1). The approach of the Kopecky model overstates the magnitude of the random variation in deposit flows between member and nonmember banks.
 - (2). The Kopecky model does not include the probability of "on-us" checks being deposited in member banks versus their being deposited in nonmember banks or thrift institutions.
 - (3). The Kopecky model misstated the deposit multiplier for nonmember banks.

Id. at 612-7.

²²⁰ *Id.* at 617.

²²¹ Farley and Simpson, *Graduated Reserve Requirements and Monetary Control*, 34 JOURNAL OF FINANCE 999 (Sept. 1979).

²²² *Id.* at 1001.

²²³ *Id.* at 1003.

²²⁴ *Id.* at 1004-5.

²²⁵ 1980 Act, *supra* note 3, Title I, § 102.

tary Control Act, which is purportedly to aid the Federal Reserve in implementing monetary policy. A review of the major proposed legislation prior to this Act, H.R. 7²²⁶ and H.R. 14072,²²⁷ shows that Congress had endorsed the idea of decreasing the total percentage of banks and demand deposits under the Federal Reserve's control.²²⁸ Under the proposed bill, H.R. 14072, as of December 1978, ninety percent of the Commercial banks would *not* be subject to any reverse requirement. Of the remaining ten percent subject to reserve requirements, one-half of this ten percent could use their vault cash holdings to meet the reserve requirements.²²⁹ In essence, ninety-five percent of all banks would have been free from holding reserves with the Federal Reserve because of a fifty million dollar exemption.²³⁰

Similarly, under the proposed version of H.R. 7 as reported in the House Report 96-263,²³¹ a smaller percentage of transaction accounts would have been covered than the amount under the Federal Reserve's control at that time. This proposed bill would have cut the amount of reserves under the Federal Reserve's control from thirty-four billion to seventeen billion or stated alternatively, a reduction from seventy-two percent to sixty-six percent of all demand deposits controlled.²³² Therefore, this proposed bill would have left a large portion of financial institutions outside the Federal Reserve's control.

Both of the proposed bills were important ancestors of the final legislation—Title I. Yet, each would have produced the strange result of decreasing the amount of demand deposits and the financial institutions within the control of the Federal Reserve. If monetary control would not be increased by these proposals, what was the intent of their proponents, who were the same proponents of Title I? One answer might be that the Federal Reserve really viewed the erosion in its membership as a threat to its political clout. With less "constituents" to plead its case, the Federal Reserve may have feared losing its prestige and independence. By coercing all financial institutions to retain mandatory levels of reserves and to file reports, the Federal Reserve could thereby expand its control.

Another possible answer is that the Federal Reserve feared the erosion of memberships because this erosion chipped away at its revenues. The revenues of the Federal Reserve are increased by increasing the level of reserves under its control. More reserves mean more money which can

²²⁶ H.R.7, 96th Cong., 2d Sess. (1979).

²²⁷ H.R.14072, 95th Cong., 2d Sess. (1978).

²²⁸ 125 CONG. REC. H6322 (daily ed. July 20, 1979) (remarks by Rep. Hinson and Henry S. Reuss); *Letter of Transmittal*, Committee on Banking, Finance, and Urban Affairs, House of Representatives, III (Dec. 30, 1978).

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ H.R. REP. NO. 96-263, 96th Cong., 2d Sess. (1979).

²³² *Id.* at 4.

be invested in interest accruing government securities. The potential loss of control of another powerful agency comes into play because the Treasury Department eventually receives most of the Federal Reserve's profits.²³³ However, sound monetary policy may not coincide with the Treasury Department's and the Federal Reserve's goal of increasing revenues. It must be pointed out the Federal Reserve's main purpose is to implement sound monetary policy, not to generate revenue.

The background of Title I is as disconcerting as the procedure used to enact it. Senator Armstrong, on the floor of the Senate, attacked certain of its provisions as not having been considered by the House or the Senate prior to the conference.²³⁴ Citing Title I, the Monetary Control Act of 1980 as a case in point, the senator stated: "Contrary to the express will of the Senate Banking Committee, [it was] made behind closed doors in a conference committee by a handful of people operating against a deadline . . . in a high pressure environment."²³⁵

Senator Morgan, during the same day, forcefully objected to the procedure of passing an act without a Senate debate on the act in final form.²³⁶ The Senator had struck the provisions concerning reserve requirements from the proposed act prior to the conference. Such provisions would have, in the Senator's view, destroyed the dual banking system.²³⁷ To the consternation of Senator Morgan the provisions were readmitted to the proposed Act and passed by the Senate. Therefore, Senator Morgan charged the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs with: "Appoint[ing] a conference committee that very carefully eliminates anyone who posed views contrary to that."²³⁸

Congress invites criticism when such a revolutionary act is enacted without Senate debate or hearings on the act in its final form. The possible ramifications as well as the legislative intent are difficult to ascertain. One is left with the haunting suspicion that Congress would have adopted any leadership-backed version of Title I in order to meet the deadline caused by the expiration of the stop-gap legislation.

The argument for Title I is that member banks have been competitively unequal with nonmember banks and thrift institutions because only member banks have supported the cost of monetary control.²³⁹ Prior to the enactment of Title I, only member banks have been required to hold noninterest-

²³³ *Monetary Control Hearings of 1979*, *supra* note 58, at 527.

²³⁴ 126 CONG. REC. S.3236 (daily ed. March 29, 1980) (remarks by Sen. Armstrong).

²³⁵ *Id.*

²³⁶ *Id.* at S.3241 (remarks by Sen. Morgan).

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Monetary Control Hearings of 1979*, *supra* note 58, at 76-77 (statement of Chairman Miller).

bearing ("sterile") reserves with the Federal Reserve. Now, the Act requires all financial institutions to hold this type of reserve in the name of equality.²⁴⁰

Opponents of universal reserve requirements contend the above arguments are misleading. Not all member banks are at a competitive disadvantage. While member banks hold more noninterest-bearing reserves than other institutions, this cost has been offset by using these balances to pay for correspondent banking services.²⁴¹ Therefore, only those banks without large correspondent businesses may have felt the cost of the Federal Reserve was too high. The problems of these banks could be alleviated more equitably by inducing them to remain in the system rather than by forcing all institutions to hold reserves. One proposed inducement was to lower reserve requirements for member banks by one-fourth.²⁴²

Also, it is argued that Title I exchanges one type of inequality for another. A claimed inequality between member banks and other financial institutions has been exchanged for an inequality between small and large financial institutions. Financial institutions subject to reserve requirements have a lower reserve ratio if their deposits are under twenty-five million dollars.²⁴³ Of course, small banks have been traditionally protected from concentrations of economic power. However, this act is legislation which purports to equalize costs, not to protect a certain segment. In fact, there is testimony that small banks are better able to compete on an equal basis and can generate more profits than large banks.²⁴⁴ Nor are the authorities in agreement on whether or not it is small banks which bear the cost burden of Federal Reserve membership.²⁴⁵ The Federal Reserve contends small banks disproportionately bear the cost of reserve requirements because they use less services.²⁴⁶ In comparison, the American Banker's Association states that net membership burden increases as the size of the financial institution increases.²⁴⁷ Therefore, larger financial institutions may actually be forced to bear a disproportionate amount of the burden by the enactment of Title I.

Title I may also increase rather than decrease inequities between financial institutions because of geographical disparities. A major flaw in treating all financial institutions alike regarding uniform reserve requirements is that each state has special needs and problems that would not be

²⁴⁰ 1980 Act, *supra* note 3, Title I, § 103.

²⁴¹ *Monetary Control Hearings of 1979*, *supra* note 58, at 372, 377 (statement of E.D. Dunn, on behalf of the Conference of State Bank Supervisors).

²⁴² *Id.* at 378.

²⁴³ 1980 Act, *supra* note 3, Title I, § 103.

²⁴⁴ *Monetary Control Hearing 1979*, *supra* note 58, at 547.

²⁴⁵ *Id.* at 522.

²⁴⁶ *Id.*, at chart III, 88.

²⁴⁷ *Id.*

considered. As enacted, Title I, in the name of equality, may cause some state banks' profits to decline disproportionately which in turn causes a disproportionate rise in rates within the affected state. Those states which had minimal, or no reserve requirements prior to the Act will be the most affected. For example, Representative Akaka, from Hawaii contends that his state will be inequitably burdened by mandatory reserve requirements.²⁴⁸ In Hawaii, a great demand for credit has been caused by rapid growth and development. However, credit is in short supply because a large percent of the investors in Hawaii are overseas investors who drain the earnings to their foreign countries.²⁴⁹ Thus, when reserve requirements are increased, Hawaiian banks have less money to loan, which stifles economic growth.

Similarly, Rhode Island's economy is negatively affected by uniform reserve requirements.²⁵⁰ Mr. Barnes, President of the Old Stone Bank, states that Rhode Island has a unique problem because its state banking laws permit every mutual savings bank to operate as a commercial bank which offers commercial loans, demand deposits, and the services of a thrift institution.²⁵¹ These hybrid banking institutions are not required to hold reserves on a majority of their deposits because under Title I savings deposits which are not subject to automatic transfer²⁵² and nonpersonal time deposits are exempt.²⁵³

In comparison, the Old Stone Bank does not have the reserve requirement exemptions applicable to the hybrid banks. As a consequence, President Barnes contends that the Old Stone Bank would have to restructure its business from transaction accounts (which require reserves) in order to be more competitive with the hybrid commercial-thrift institutions.²⁵⁴ Thus, one of the Rhode Island's largest residential mortgage lenders, the Old Stone Bank, would be induced to raise its interest rates and make less consumer loans; both actions which would negatively affect Rhode Island residents.

According to H. Lee Boatwright, the consumers of Maryland would also be inequitably burdened by reserve requirements determined by the Federal Reserve.²⁵⁵ His bank predominantly serves bedroom communities for Washington, D.C., which are more retail oriented than other industrialized areas. Maryland banks in this area devote more of their loans to consumers, such as home mortgages, than do banks of similar size else-

²⁴⁸ *Id.* at 444 (statement of Rep. Akaka, from Hawaii).

²⁴⁹ *Id.*

²⁵⁰ *Monetary Control Hearing of 1978, supra* note 44, at 562 (statement of Theodore Barnes, Pres. of Old Stone Bank, R.I.).

²⁵¹ *Id.* at 563.

²⁵² 1980 Act, *supra* note 3, Title I, § 103.

²⁵³ *Id.*

²⁵⁴ *Monetary Control Hearings 1978, supra* note 44, at 563-4.

²⁵⁵ *Id.* at 587 (statement of H. Lee Boatwright, Pres. of Suburban Trust Co., Md.).

where.²⁵⁶ This concentration on consumer loans has the added cost factors of consumer default and low yields as to accrual of interest. Additional cost of required reserves would induce these banks to shift from consumer loans to higher yield loans.

This is not the only consumer oriented banking system which would be inequitably burdened by uniform reserves. The Manufacturer's Bank of Los Angeles, California contends that uniform reserve requirements would deter them from loaning to small businesses because California banks would not be willing to assume the added cost of reserves as well as the risks characteristic of small business loans.²⁵⁷

Another inequality related to the geographical distinctions between financial institutions is the inequality between rural banks and those located near Federal Reserve banks.²⁵⁸ Basically, a bank which is not located near a Federal Reserve bank or branch and does not have a large volume of checks cannot meet the Federal Reserve deadlines for receipt of checks to be cleared.²⁵⁹ Thus, rural banks use Federal Reserve services less than those located near Federal Reserve Banks. These distant banks must hold additional reserves with correspondent banks which provide them with check clearing services. Uniform reserve requirements would heighten the competitive disadvantage of rural banks because now they have to hold double the reserve levels of other banks. Again, these costly inequities would be passed on to small businesses and consumers who may seek loans.

Title I has other provisions which may cause inequities. The National Savings and Loan League have expressed their concern over the increased cost of double examinations and reporting requirements.²⁶⁰ The potential duplication may arise from the overlapping jurisdiction of two federal agencies, the Federal Home Loan Bank Board and the Federal Reserve Board.²⁶¹ Although the Federal Home Loan Bank Board has traditionally regulated thrift institutions, now that the Federal Reserve has the power to impose reserve requirements, reporting requirements, and examinations, there may be a conflict. In effect, thrift institutions are at a competitive disadvantage with state banks which have the option of changing to or adopting a national charter in order to escape double costs. Savings and loans do not have the option of leaving the Federal Home Loan Bank

²⁵⁶ *Id.* at 588.

²⁵⁷ *Id.* at 598 (statement of Leonard Weil, Pres. of Manufacturers Bank, Los Angeles, Calif.).

²⁵⁸ *Id.* at 693, 695-6 (statement of Lewis Holding, Pres. of First-Citizens Bank and Trust Co., North Carolina).

²⁵⁹ *Id.* at 695-8.

²⁶⁰ *Monetary Control Hearing of 1979, supra* note 58, at 703 (statement of Jonathan Lindley on behalf of the National Savings and Loan League).

²⁶¹ *Id.* at 705.

Board for the Federal Reserve System should this move prove more profitable.²⁶²

Another major concern of thrift institutions is that uniform reserve requirements will affect their economic health, and in turn the housing market.²⁶³ As Senator Morgan states, "Then where will we go to get our home loans? Savings and loans finance about 60 percent of the home loans in this country. I predict in the next two years that will drop to 40 percent or less."²⁶⁴ The liquidity of savings and loans may be impaired because their reserves no longer bear interest under the new Act. Previously, the thrift institutions had held reserves in highly marketable short-term money market securities.²⁶⁵ The inequality between thrift institutions and commercial banks is further emphasized because commercial banks offer a wider range of services and are located in convenient locations for banking clientele.²⁶⁶

3. The goal of equality may be outweighed by the harmful effects on the banking system

The delicate balance between Federal and State banking powers may be destroyed because Title I has shifted more power to the Federal Reserve. As a result, state banks may convert to a national charter. In essence, Title I may have caused a migration from state charters to national charters in an overzealous attempt to stem federal reserve membership erosion.

One reason for state banks to convert to a national charter would be to avoid the added costs of double reporting requirements and examinations. Such double requirements are costly because employees' efforts are diverted from banking business to fulfilling the requirements.

Another incentive for adopting or defecting to a national charter would be to escape higher reserve requirements. The Monetary Control Act of 1980 does provide that reserve requirements may be used to satisfy liquidity requirements imposed by state or federal law.²⁶⁷ However, if the state reserve requirements are higher than the levels imposed by the Federal Reserve, the state banks would be induced to cut costs by joining the Federal Reserve system. This scenario is supported by the Conference of State Bank Supervisors' Report which found that several states do have higher reserve levels than the levels proposed in H.R.7 which are similar to the present Federal Reserve levels.²⁶⁸

²⁶² However, see Title VIII of the 1980 Act which may provide a solution to this problem.

²⁶³ *Monetary Control Hearing of 1979*, *supra* note 58, at 689, 695-9 (statement of the U.S. League of Savings Assn.).

²⁶⁴ 126 CONG. REC. S.3242 (daily ed. March 28, 1980) (remarks of Sen. Morgan).

²⁶⁵ *Monetary Control Hearings of 1979*, *supra* note 58, at 696.

²⁶⁶ *Id.* at 698.

²⁶⁷ 1980 Act, *supra* note 3, Title I, § 104.

²⁶⁸ H.R. REP. NO. 96-263, 96th Cong., 2d Sess. 38. (Supplemental views of Rep: Stanton).

The bottom line is that the dual banking system may be in jeopardy by the enactment of the Monetary Control Act of 1980. If this is the result of the Act, the goal of equalizing the burden of monetary policy becomes inconsequential compared to the establishment of a centralized banking system. Americans have traditionally been suspicious of concentrated power which does not afford the checks and balances necessary to maintain equality.

The Federal Reserve has virtually become the "fourth" arm of the government because Congress has delegated broad powers over the monetary system to the Federal Reserve.²⁶⁹ Most of the time, policy decisions are made without even reporting why the Board of Governors reached their decisions.²⁷⁰ Even a President's power over the Federal Reserve is sharply limited because each member of the Board of Governors is elected for a fourteen year term which may not coincide with a President's term of office. Therefore, the President may or may not be able to choose members of the Board of Governors which will follow his administration's policies.²⁷¹ This semi-independent status of the Federal Reserve has created controversy. Many feel the Federal Reserve should be made more responsible to Congress and the President because monetary policy is an integral part of the national economic policy. If more banks become Federal Reserve banks, the administration may be unable to establish or coordinate an overall economic policy should a more powerful Federal Reserve decide to take an opposite action.

4. Was Title I the best solution to the erosion of membership in the Federal Reserve?

The major alternative proposal to Title I was a voluntary approach wherein banks would be induced to join the Federal Reserve system by the lure of interest paid on required reserves. By paying interest on reserves, banks would not withdraw from the system or choose a state rather than a federal charter.

Representative Stanton proposed such a bill, "The Freedom of Choice Compromise" in the Ninety-Sixth Congress.²⁷² Stanton advocated a voluntary system because such a system has been in existence since 1931. As long as the system works, why implement a drastically different structure which has never been tried before in the United States? As previously stated, there have been few, if any, scholarly studies in support of mandatory reserves. Even assuming that such studies exist, these studies would be untried in reality.

The Stanton proposal incorporated the premise that the banking

²⁶⁹ See generally, Patman, *What's Wrong with the Federal Reserve and What to Do about it*, 61 A.B.A.J. 179 (Feb., 1975).

²⁷⁰ *Id.* at 180.

²⁷¹ 12 U.S.C. § 242 (1976).

²⁷² H.R. REP. No. 96-263, 96th Cong., 2d Sess. 37 (1979).

structure should be changed as little as possible in any effort to stem the flow of members from the Federal Reserve.²⁷³ Under the Stanton bill, reserve requirements would not be initially applied to any but Federal Reserve members.²⁷⁴ The new twist was that reserve levels would be lowered below the levels endorsed by the Federal Reserve and interest would be paid on those reserves.²⁷⁵ In the event the membership continued to erode, and demand deposits under Federal control dropped below sixty-six percent, reserve requirements would be mandatory for all financial institutions.²⁷⁶

The effect of the Stanton Bill would have been to increase the number of banks and reserve requirements under Federal Reserve control without extending such control over nonmembers and thrift institutions in the absence of an emergency.²⁷⁷ In the final analysis, the Stanton bill would have strengthened the voluntary system and worked to reduce a member bank's motives for leaving the Federal Reserve system.

E. Conclusion

This commentator supports the Stanton bill rather than the enacted version of Title I. This proposal would have been the best answer to the "problem" of the membership decline in the Federal Reserve System. Unlike the enacted version which required all financial institutions to hold reserves with the Federal Reserve Banks, the Stanton proposal relies on a voluntary approach which only becomes mandatory if reserves fall below a set level. The benefit of such a combined approach is twofold. One, it is a prudent solution which changes incrementally rather than radically a banking system which has been viable for sixty-eight years. Second, the Federal Reserve System could have been adequately protected by the automatic emergency reserve measures without burdening financial institutions with the cost of reserves during a stable economy.

The adoption of a radical and untried banking system which enlarges the powers of the autonomous Federal Reserve is even more incongruous because Title I may be a solution to a nonexistent problem. As previously stated not all banking experts agree that the decline in Federal Reserve membership would have been disastrous to efficient monetary policy. Nor did the experts agree that the Federal Reserve should rely more on varying reserve ratios in order to implement monetary policy. In comparing the cost burden of mandatory reserves to the necessity of reserves as a monetary tool, less obtrusive monetary tools such as the discount rate and open-market operations would have been a wiser choice.

²⁷³ *Id.*

²⁷⁴ *Id.* at 38.

²⁷⁵ *Id.* at 39.

²⁷⁶ *Id.* at 40.

²⁷⁷ *Id.* at 39.

Therefore, this commentator believes Congress overreacted to an inaccurately perceived problem, one which, if it existed, could have been solved without encroaching upon the freedom of choice which had been the bulwark of the American banking system prior to Title I.

TITLE II: DEPOSITORY INSTITUTIONS DEREGULATION ACT OF 1980

A. *Background of Title II*

Title II of The Depository Institutions Deregulation and Monetary Control Act of 1980²⁷⁸ will have far reaching effects on the public. It will mean greater earnings on savings for everyone with a savings account without sacrificing the safety of federally insured deposits or the liquidity of a passbook. This part of the Act has caused much furor since it was enacted. In order to understand the controversy presently surrounding this section some background to Title II must be explained.

On May 22, 1979, President Carter sent a message to Congress concerning the rate ceiling on deposit interest rates.²⁷⁹ The President felt that these ceilings discriminated against the small saver who was not able to purchase market rate securities due to insufficient funds.²⁸⁰ This is the saver who must have his funds made available to draw from on short notice and so must sacrifice the market rate instruments, which tie up savings for a period of time, in order to have this liquidity. The President's message also stated a concern that the small savers were pulling out of those savings plans subject to these ceilings offered by banks and thrift institutions and were going into the financial marketplace with its new investment alternatives, such as the Money Market Mutual Funds. These investment alternatives offered the small saver the going market rate as opposed to the 5.5% or 5.25% that the regulated institutions offered as well as the liquidity that the small saver needed for his funds.²⁸¹ The drawback to these funds was that they were not insured by the federal government and so may not have been perceived as safe by the small saver who wanted more for his money but certainly could not afford to lose any of his life savings trying to get it. Lastly, the President felt that savers would prefer a higher yield on their savings as opposed to non-price competition that financial institutions were using to attract depositors, such as merchandising gifts.²⁸²

²⁷⁸ 1980 Act, *supra* note 3, Title II.

²⁷⁹ *Depository Institutions Deregulation Act of 1979: Hearings on S.1347 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking, Housing, and Urban Affairs* (Part I) 96th Cong., 1st Sess. 5 (1979) [hereinafter cited as *S.1347 Hearings*].

²⁸⁰ *Id.*

²⁸¹ *Id.* at 6.

²⁸² *Id.*

In his message, the President offered several proposals to help both the small saver and the financial institutions that must pay the higher earnings on the savings. The proposal that is important to this section of the article is the one in which the President asked Congress:

to provide that through an orderly transition period all deposit interest rates be permitted to rise to market rate levels. This will be subject to emergency action on the part of the responsible regulators if the safety and soundness of financial institutions is threatened or the implementation of monetary policy so requires.²⁸³

This recommendation came about after review of the report of the President's Inter-Agency Task Force on Regulation Q.²⁸⁴

Legislation was introduced in the Senate on June 14, 1979 which was intended to carry out the proposals of the President's message.²⁸⁵ The bill, which was introduced by Senator Cranston and Senator Proxmire, would have phased out Regulation Q over the course of ten years.²⁸⁶ This was to be accomplished by raising the ceiling one quarter of one percent every six months starting in 1982 and continuing through 1989.²⁸⁷ Starting in 1990 there was to be no ceiling, but stand-by authority to reimpose rate ceilings after 1990 under emergency circumstances would have existed.²⁸⁸ Authority would also have existed to postpone the raising of the ceiling for up to one year.²⁸⁹ On September 24, 1979 the Committee on Banking, Housing and Urban Affairs considered S. 1347 and after approval of some amendments reported it as a substitute for H.R. 4986,²⁹⁰ the House bill that was to give many of the powers to financial institutions found in S. 1347 but which did not have a Regulation Q phase-out provision. After the bill was reported out of committee it passed the Senate on November 1, 1979.²⁹¹

The two Houses were unable to reach an agreement on the differences in the bills on December 5, 1979 and agreed to reconvene on March 4, 1980.²⁹² In the meantime, other phase-out plans had been introduced and discussed in the House hearings on the Regulation Q phase-out.

²⁸³ *Id.*

²⁸⁴ THE REPORT OF THE PRESIDENT'S INTER-AGENCY TASK FORCE ON REGULATION Q, DEPOSIT INTEREST CEILINGS AND HOUSING CREDIT.

²⁸⁵ S. 1347 *Hearings, supra* note 279, at 8.

²⁸⁶ *Id.* at 4.

²⁸⁷ *Id.* at 19.

²⁸⁸ *Id.* at 21.

²⁸⁹ *Id.* at 20.

²⁹⁰ S. REP. No. 96-368, 96th Cong., 1st Sess. 2, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 834, 835.

²⁹¹ S. REP. No. 96-368, 96th Cong., 1st Sess. 1 *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 834, 835.

²⁹² 1980 *House Reg. Q. Hearings, supra* note 2, at 1 (opening statement of Chairman St. Germain).

The provisions of these plans were as follows: H.R. 6198 would have gone into effect on July 1, 1980 and continued until July 1, 1985. Ceilings were to be lifted starting with the longest term certificates. This bill contained no provision for postponement during the phaseout. Authority to reimpose controls after July 1, 1985 was to be held only by the Federal Reserve Board for the period of one year in an extreme economic emergency.²⁹³ H.R. 6216 had no deadline but contained a provision that beginning in 1985 regulators would bring passbook rates to market level as soon as possible.²⁹⁴

Finally, Congressman St. Germain made a proposal at the beginning of the Financial Institutions Subcommittee Hearings on the phase-out of Regulation Q in H.R. 4986.²⁹⁵ Mr. St. Germain's proposal was to phase out Regulation Q over five years, requiring a one half of one percent increase in the first year and other increases at the discretion of the regulators. This proposal contained no emergency reimposition powers for the regulators. On March 4, 1980, the conferees agreed on a compromise bill which was passed by the House on March 27, 1980 and by the Senate on March 28, 1980.²⁹⁶ This compromise bill had nothing in common with the various proposals mentioned above. However, the overall goal of deregulation seems to have been well served.

B. *Review of Title II*

Upon enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980, the manner in which rate ceilings are determined changed and so did the philosophy behind rate ceiling regulation. First, the Depository Institutions Deregulation Committee was formed (hereinafter Deregulation Committee).²⁹⁷ The Deregulation Committee is made up of the following members: the Secretary of the Treasury, the Chairman of the National Credit Union Administration Board, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Board of Directors of the Federal Deposit Insurance Corporation and the Chairman of the Federal Home Loan Bank Board, all of whom are the voting members of the Deregulation Committee.²⁹⁸ The Comptroller of the Currency is also a member of the Deregulation Committee but is a nonvoting member.²⁹⁹ The authority transferred to the Deregulation Committee had previously been with the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Board of Directors of the Fed-

²⁹³ *Id.* at 36-37 (statement of Jay Janis, Chairman FHLBB).

²⁹⁴ *Id.* at 37.

²⁹⁵ *Id.* at 2.

²⁹⁶ [1980] U.S. CODE CONG. & AD. NEWS 834.

²⁹⁷ 1980 Act, *supra* note 3, Title II, § 203 (to be codified at 12 U.S.C. § 3502).

²⁹⁸ *Id.*

²⁹⁹ *Id.*

eral Deposit Insurance Corporation and the Chairman of the Federal Home Loan Bank Board.³⁰⁰ The Deregulation Committee determines a change in interest rate ceilings by a majority of its voting members.³⁰¹ Under the rate setting system that had existed, the regulators consulted with each other on increases and no vote was taken, but because of the legally mandated differential given to thrift institutions, no increase could be instituted without the Federal Home Loan Bank Board increasing the ceiling for thrift institutions.³⁰² This individual authority to set rates is now eliminated and rates are increased by a majority vote of the Deregulation Committee, no matter what an individual regulator may decide.³⁰³

In order to ensure that deregulation would proceed in an orderly fashion, Congress gave the Deregulation Committee targets for the phase-out of Regulation Q.³⁰⁴ These targets are not, however, fixed standards.³⁰⁵ Rather, they are guidelines to be followed. During the first eighteen months after enactment, an increase of one quarter of one percent on permissible passbook rates was set.³⁰⁶ Other rates during this period may be increased, but this is not mandated.³⁰⁷ Starting with the third year of this phase-out and continuing through the sixth year, a one half of one percent increase is targeted on all classes of accounts for each year.³⁰⁸ The Deregulation Committee may either exceed these targets if economic conditions warrant this type of action or may refrain from increases on the permissible rate if conditions in the economy warrant.³⁰⁹ The Deregulation Committee also has the discretion to selectively increase or decrease permissible rates on any class of deposits or, should economic conditions mandate, lower the permissible rates on any or all accounts.³¹⁰ This authority may be exercised at any time during the six year period.³¹¹ The Deregulation Committee is not restricted to this formula of phase-out.³¹² The Deregulation Committee may combine the phase-out formula and its targets with newly created types of deposits that are not subject to any ceiling or have ceilings that are

³⁰⁰ *Id.*

³⁰¹ *Id.*

³⁰² Pub. L. No. 94-200, Title I, § 102, 89 Stat. 1124 (1975). (noted after 12 U.S.C. § 461 (1976)).

³⁰³ H.R. REP. No. 96-842, 96th Cong., 2nd Sess. 73, reprinted in [1980] U.S. CODE CONG. & AD. NEWS 901.

³⁰⁴ 1980 Act, *supra* note 3, Title II, § 205 (to be codified at 12 U.S.C. § 3504(a)).

³⁰⁵ *Id.* (to be codified at 12 U.S.C. § 3504(b)).

³⁰⁶ *Id.* (to be codified at 12 U.S.C. § 3504(a)).

³⁰⁷ *Id.*

³⁰⁸ *Id.*

³⁰⁹ H.R. REP. No. 96-842, 96th Cong., 2nd Sess. 72-73, reprinted in [1980] U.S. CODE CONG. & AD. NEWS 900.

³¹⁰ *Id.* at 73; [1980] U.S. CODE CONG. & AD. NEWS 901.

³¹¹ *Id.*

³¹² *Id.* at 72; [1980] U.S. CODE CONG. & AD. NEWS 900.

linked to the market-rate.³¹³ The new class of accounts need not have a differential between thrift institutions and commercial banks.³¹⁴

The latitude extended to the Deregulation Committee on ways to phase out Regulation Q was not also extended to the procedures the Deregulation Committee must follow in administering the phase-out. The Deregulation Committee must meet at least quarterly in public sessions.³¹⁵ The business of the Deregulation Committee is to be conducted in conformity with the Sunshine Act and the Freedom of Information Act.³¹⁶ The Deregulation Committee may not eliminate the differential on classes of accounts subject to Public Law 94-200 but may increase rates on these accounts provided the differential is maintained.³¹⁷ The lack of observance of procedures and restrictions were later challenged by the U.S. League of Savings and Loans when the rates were changed by the Deregulation Committee on Money Market Certificates and Small Saver Certificates.³¹⁸

The Deregulation Committee and its Regulation Q authority expires six years after enactment of the legislation.³¹⁹ The reason for the six year extension is to permit the thrift institutions enough time to incorporate the new powers given them in the remainder of the Depository Institutions Deregulation and Monetary Control Act of 1980.³²⁰ The new powers were given to the thrift institutions in order to create competitive equity among commercial bank and thrift institutions and to make up for the loss of the differential.³²¹ After the expiration of Regulation Q the depository institutions will be able to compete directly with nondepository institutions for savings, thus creating an opportunity for the small saver to receive market rates in insured institutions.

C. *Subsequent Regulatory Action*

The Deregulation Committee, although a new and innovative idea, is certainly not controversial and with all these guidelines and procedures should not have been the cause of great concern. Unfortunately, this has not been the case. On May 20, 1980 the Deregulation Committee met in a closed

³¹³ *Id.* at 73; [1980] U.S. CODE CONG. & AD. NEWS 901.

³¹⁴ *Id.*

³¹⁵ 1980 Act, *supra* note 3, Title II, § 203 (to be codified at 12 U.S.C. § 3502(b)).

³¹⁶ "All meetings of the Deregulation Committee shall be conducted in conformity with the provisions of section 5526 of Title 5" *Id.* See also legislative history at [1980] U.S. CODE CONG. & AD. NEWS 900.

³¹⁷ Pub. L. No. 94-200, Title I, § 102(a), 89 Stat. 1124 (1975); see also [1980] U.S. CODE CONG. & AD. NEWS 901.

³¹⁸ Complaint of Plaintiff at 7-10, United States League of Savings Association v. Depository Institution Deregulation Committee, No. 80-1486 (D.C.D.C., filed June, 1980).

³¹⁹ 1980 Act, *supra* note 3, Title II, § 202(a) (to be codified at 12 U.S.C. § 3501(b)).

³²⁰ H.R. REP. No. 96-842, 96th Cong. 2nd Sess. 72 (1980). reprinted in [1980] U.S. CODE CONG. & AD. NEWS 896, 900.

³²¹ *Id.*

session to consider the differential on the Money Market Certificate.³²² This caused a great deal of commotion in the financial industry, with the American Bankers Association asking for removal of the differential and the United States League of Savings Associations asking for the retention of the differential at all levels of Money Market Certificates.³²³ The meeting produced no decision on the differential. A second meeting on May 23, 1980, also in closed session, produced no decision, but the Deregulation Committee announced an open meeting on May 28, 1980.³²⁴ The meeting of May 28, 1980 produced Rule No. 0008.³²⁵ This rule is very technical and deserves some explanation. It deals with the differentials on certificates sold by the depository institutions. These differentials allow the thrifts to pay a higher percentage of return on savings of all types which ultimately helps the thrifts compete for funds. For example, in the area of Money Market Certificates, the rate is pegged to the six month Treasury bill average weekly auction rate. If the average auction for a Treasury bill is below 7.25 percent, the ceiling for both the commercial banks and the thrift institutions is 7.75 percent with no differential for the thrift institutions. If the Treasury bill average is 7.25 - 7.50 percent the ceiling for the commercial banks is 7.75 percent and the thrift ceiling is the Treasury bill rate plus .50 percent, giving the thrifts a differential ranging from .25 - 0 percent. When the Treasury bill average is 7.50 - 8.50 percent the commercial bank ceiling is the Treasury bill rate plus .25 percent and the thrift ceiling is the Treasury bill rate plus .50 percent, according the thrifts a differential of .25 percent. When the Treasury bill rate is 8.50 - 8.75 percent, the commercial bank ceiling is the Treasury bill rate plus .25 percent and the thrift ceiling is 9.00 percent, giving the thrifts a differential of 0 - .25 percent. At 8.75 percent and above on the Treasury bill average, the ceiling for commercial banks and thrifts is the Treasury bill rate plus .25 percent with no differential.³²⁶ The commercial bank may also renew Money Market Certificates to existing customers at the same rate that the thrifts offer them.³²⁷ This new ceiling schedule replaced the old ceilings in which the commercial banks rates were the same as the Treasury bill auction average.³²⁸ The thrift ceiling under the old ceiling system was given a .25 percent differential when the Treasury bill average was 8.74 percent or lower.³²⁹ The thrifts could pay 9.00 percent when the Treasury bill average was between 8.75 and 9.00 percent.³³⁰

³²² Washington Notes, May 16, 1980 at 1.

³²³ *Id.*

³²⁴ *Id.*, May 23, 1980 at p. 6.

³²⁵ 45 Fed. Reg. 37,803 (1980) (to be codified at 12 C.F.R. §§ 1204.104-1204.106). Rule 0008 is a docket number on the Deregulation Committee's activities.

³²⁶ *Id.* This information is taken from a table set out in the Federal Register.

³²⁷ *Id.* This was only true 6 months after promulgation.

³²⁸ 43 Fed. Reg. 21,435 (1978) (codified at 12 C.F.R. § 217.7(f)).

³²⁹ 44 Fed. Reg. 15,477 (1979).

³³⁰ *Id.*

When the Treasury bill average was 9.01 and above, the thrifts paid the same as the Treasury bill average and there was no differential.

The Deregulation Committee did not stop with the new rate ceilings on Money Market Certificates; rates were also increased on Small Saver Certificates. Although these increases are not as complicated, they are also a point of contention and so should be explained. The Small Saver Certificate is based on the Treasury Composite Rate on thirty month Treasury securities.³³¹ The Small Saver Certificate rate is determined bi-weekly.³³² When the Treasury Composite Rate is 9.50 percent or below, the commercial bank ceiling is 9.25 percent and the thrift ceiling is 9.50 percent, the differential being .25 percent.³³³ When the Treasury Composite Rate is 10 percent, the commercial bank ceiling is 9.75 percent and the thrift rate is 10 percent with a .25 percent differential.³³⁴ When the Treasury Composite Rate is 11 percent, the commercial bank ceiling is 10.75 percent and the thrift ceiling is 11 percent, giving a differential of .25 percent.³³⁵ When the Treasury Composite Rate is 12 percent and above, the commercial bank ceiling is 11.75 percent and the thrift ceiling is 12 percent, also giving a .25 percent differential. Previously, the changes in the ceiling of the Small Saver Certificate rates were determined by the Treasury Composite Rate minus three-quarters of one percent for commercial banks. The thrift rate was the Treasury Composite Rate minus one-half of one percent, so a differential of .25 percent was built into the rates.³³⁶

D. *Challenge by the United States League of Savings Associations*

To say the least, the thrifts were not pleased by the turn of events. The loss of the differential, except for limited circumstances on money market certificates and the one half of one percent increase on small saver certificates, would cost the thrifts money. The United States League of Savings Associations, which is a national trade association with a membership of approximately 4,500 savings and loan associations, was so displeased that, as a result, it filed suit.³³⁷ In the action, the Deregulation Committee and its members are named both individually and in their capacity as members.³³⁸ There is one exception to this: defendant Jay Janis is not named individually but solely in his capacity as a member of the Deregulation

³³¹ 44 Fed. Reg. 75,621 (1979) (codified at 12 C.F.R. § 217.7(g)), (Fed. Reserve); 44 Fed. Reg. 75,378 (1979) (codified at 12 C.F.R. § 329.7(b)(10)) (FDIC); 44 Fed. Reg. 75,625 (1979) (codified at 12 C.F.R. § 526.3(a)(4)) (FHLBB).

³³² 45 Fed. Reg. 37,804 (1980) (to be codified at 12 C.F.R. § 1204.106(a)).

³³³ *Id.*

³³⁴ *Id.*

³³⁵ *Id.*

³³⁶ 44 Fed. Reg. 75,625 (1979) (codified at 12 C.F.R. § 526.3(a)(4)(ii)).

³³⁷ United States League of Savings Associations v. Depository Institutions Deregulation Committee, No. 80-1486, (D.C.D.C. filed June, 1980).

³³⁸ *Id.* Complaint of Plaintiff at 2-3.

lation Committee.³³⁹ This is unusual, for Mr. Janis is a voting member of the Deregulation Committee and voted for Rule 0008. Defendant John G. Heimann is named individually and he is a non-voting member of the Deregulation Committee.³⁴⁰ The difference may be that Jay Janis is Chairman of the Federal Home Loan Bank Board which regulates the members of the United States League of Savings Associations and John Heimann is Comptroller of the Currency, which has no regulating powers over the members of the Association. After going to the trouble of naming these members of the Deregulation Committee individually the League asked for no damages against them, but only a declaratory judgment and preliminary and permanent injunctions against the Deregulation Committee.³⁴¹ These facts may not imply intentional harassment, but they raise a specter of doubt as to the motive for naming five of the members individually.

The complaint listed eleven counts which will now be discussed along with the reply of the Deregulation Committee. In the first count of the complaint the United States League of Savings Associations (hereinafter the U.S. League) claims that the Deregulation Committee is not permitted under Title II of Public Law 96-221 to eliminate or reduce in part or in whole the differential on existing classes of deposits and accounts.³⁴² Even if the Deregulation Committee does have the authority to do this, it violated section 206 of Public Law 96-221 by not waiting until after the annual individual reporting by members of the Deregulation Committee to Congress had been made regarding the effect that removal of the differential would have on the housing industry and the thrifts. Thus, according to the League, the Deregulation Committee violated section 206 by acting within two months and not waiting until after the first annual reports.³⁴³

The U. S. League fails to recognize some very important facts in their bringing of this count. First, the fact that there is a legally mandated differential is of no consequence because the mandate applies only to classes of accounts in existence on December 10, 1975.³⁴⁴ The classes of accounts involved in the complaint were created after that date and, as such, are not under the mandate.³⁴⁵ If Congress had wanted to change the mandate to

³³⁹ *Id.* at 3.

³⁴⁰ *Id.*

³⁴¹ *Id.*

³⁴² Complaint of Plaintiff at 11-13.

³⁴³ *Id.* at 12-13.

³⁴⁴ Pub. L. No. 94-200, § 102(a), 89 Stat. 1124, (noted after 12 U.S.C. § 461). This section made differentials in existence on December 10, 1975 unchangeable without congressional action.

³⁴⁵ Market Certificates were first authorized at 43 Fed. Reg. 21,435 (1978) (codified at 12 C.F.R. § 217.7(f)), (Fed. Reserve), 43 Fed. Reg. 21,436 (codified at 12 C.F.R. § 329.6 (b)(5)), (FDIC); 43 Fed. Reg. 21,438 (codified at 12 C.F.R. § 526.5(a)) (FHLBB); while small saver certificates were first authorized at 44 Fed. Reg. 75,621 (codified at 12 C.F.R. § 217.7(g)) (1979) (Fed. Reserve); 44 Fed. Reg. 75,378 (codified at 12 C.F.R. § 329.7(b)(10)) (1979) (FDIC); 44 Fed. Reg. 75,625 (1979) (codified at 12 C.F.R. § 526.3(a)(4)) (FHLBB).

include accounts created after 1975 it could have enacted legislation to do so.

Section 209 of the Act provides that regulations of the Federal Deposit Insurance Corporation (hereinafter F.D.I.C.), the Federal Home Loan Bank Board (hereinafter Bank Board) and the Federal Reserve Board remain in effect until repealed, amended or superseded by the Deregulation Committee.³⁴⁶ The F.D.I.C. and Federal Reserve Board have taken action in the past on IRA and Keogh accounts created after the mandated differential to eliminate or reduce the differential.³⁴⁷ With the transfer of their authority in section 203 to the Deregulation Committee tempered by the provisions of section 209,³⁴⁸ an examination of prior regulations is essential.

Formerly, thrifts could pay the Treasury bill rate plus one quarter of one percent on money market certificates.³⁴⁹ Subsequently, however, the F.D.I.C. and the Bank Board established the Treasury bill rate as the ceiling when this rate reached nine percent. This was done to relieve pressure on the thrifts because the sharply rising interest rates were depressing earnings.³⁵⁰ This action stripped the differential when the Treasury bill rate reached nine percent.³⁵¹ A similar logic was used in the promulgation of the new rates. The Deregulation Committee feared that the commercial banks would lose funds from the Money Market Certificates if the regulation remained in its present form, thus hurting the commercial banks' ability to make business loans.³⁵² Similarly, commercial banks were permitted by the Federal Reserve Board and the F.D.I.C. to pay the maximum rates payable by thrifts on accounts under \$100,000 on I.R.A. and Keogh deposits.³⁵³ As a result, the actions of the Deregulation Committee are not unique but are analogous to actions by the prior regulating authorities.

The second count of the U.S. League's complaint asserts that the Deregulation Committee violated Congressional intent by acting on the intent by acting on the interest rate before the thrifts had an opportunity to implement new powers given them in the Act.³⁵⁴ The U.S. League also asserts that the minimum ceilings violate the Congressional intent not to allow ceiling rates to go above market rates. This second assertion will be handled in count five which also deals with this problem.

³⁴⁶ 1980 Act *supra* note 3, at § 209, (to be codified at 12 U.S.C. 3508).

³⁴⁷ 42 Fed. Reg. 20,284 (1977) (codified at 12 C.F.R. § 217.7(e)) (Fed. Reserve); 42 Fed. Reg. 21,272 (1977) (codified at 12 C.F.R. § 329.6(b)(4) and § 329.7(b)(6)) (FDIC).

³⁴⁸ 1980 Act *supra* note 3, § 209 (to be codified at 12 U.S.C. § 3508).

³⁴⁹ 43 Fed. Reg. 21,438 (1978) (then codified at 12 C.F.R. § 526.5(a)).

³⁵⁰ 12 C.F.R. § 526.3(a)(8)(iii) (1980).

³⁵¹ *Id.*

³⁵² Memorandum of Defendant at 8.

³⁵³ 42 Fed. Reg. 20,284 (1977) (codified at 12 C.F.R. § 217.7(e)) (Fed. Reserve); 42 Fed. Reg. 21,272 (1977) (codified at 12 C.F.R. § 329.6(b)(4) and § 329.7(b)(6)) (FDIC).

³⁵⁴ Complaint of Plaintiff at 13-16, *see* H.R. REP. No. 96-842 at 72, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 900.

The Deregulation Committee, it must be remembered, did not phase out all differentials; only the differential on the Money Market Certificate has been altered. The only other action taken by the Deregulation Committee was the increase in rates on Small Saver Certificates.³⁵⁵ The prior regulatory agencies, however, were under no limitation on when they could act, so the transfer of this authority to the Deregulation Committee should mean that the Deregulation Committee could also act at any time.³⁵⁶ Even if this is not accepted, the language of section 204 directs the Deregulation Committee to phase out the limitation to market rates "as soon as feasible" and "as rapidly as economic conditions warrant."³⁵⁷ This language, taken in conjunction with the fact that section 205 sets targets that may or may not be implemented at the Deregulation Committee's discretion to act within the first eighteen months on the permissible rates paid on these types of accounts, gives the Deregulation Committee the authority to act in such a manner.³⁵⁸ Under the U.S. League's assertion, the Deregulation Committee could only act after the annual reports of its Members. This interpretation is contrary to the language of section 205.³⁵⁹ Furthermore, the Deregulation Committee could only act after these powers were fully in effect. This position is also contrary to the discretion granted to the Deregulation Committee in the Act.³⁶⁰ Although phase-out of Regulation Q is linked with the new powers granted thrifts, the Deregulation Committee has not phased out Regulation Q entirely, nor can they without Congressional action on certain classes of accounts.³⁶¹

In the third count of the complaint the U.S. League asserts that the Deregulation Committee failed to give "due regard for the safety and soundness of depository institutions"³⁶² as mandated in the Act.³⁶³ They further assert that the Congressional intent was violated in that the "competitive equity among [different classes of] depository institutions" was not ensured.³⁶⁴

These assertions ignore the fact that the Deregulation Committee exists to protect depository institutions, which includes commercial banks as well as thrifts.³⁶⁵ It was determined by the Deregulation Committee that

³⁵⁵ 45 Fed. Reg. 37,803 (to be codified at 12 C.F.R. §§ 1204.104-106) (1980).

³⁵⁶ 1980 Act, *supra* note 3, § 209 (to be codified at 12 U.S.C. § 3508).

³⁵⁷ *Id.*, § 204, (to be codified at 12 U.S.C. § 3503(a)).

³⁵⁸ *Id.*, § 205 (to be codified at 12 U.S.C. § 3504(b)).

³⁵⁹ *Id.*

³⁶⁰ *Id.*

³⁶¹ This is due to the strictures of Pub. L. No. 94-200, Title I, § 102, 89 Stat. 1124 (noted after 12 U.S.C. § 461 (1975)).

³⁶² 1980 Act, *supra* note 3, Title II, § 204(b) (to be codified at 12 U.S.C. § 3503(b)).

³⁶³ Complaint of Plaintiff at 16-17.

³⁶⁴ H.R. REP. No. 96-842, 96th Cong., 2nd Sess. 73 (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 901.

³⁶⁵ *Id.*

reduction in the differential would decrease the likelihood of outflow of deposits from commercial banks to thrifts.³⁶⁶ This outflow, it was feared, would impair the commercial banks' ability to make business loans.³⁶⁷ The Deregulation Committee also looked at the effects this action would have on thrifts. It was determined that the flow to thrifts, although resulting in an absolute increase, would not rise as sharply as it would without the reduction.³⁶⁸ Assuming that these allegations can be substantiated, it is difficult to see how the League can successfully assert that the Act, and Congressional intent behind it, was violated by the Deregulation Committee.

The fourth count claims that some members of the Deregulation Committee are prejudiced or biased against the differential and/or Savings and Loans. The U.S. League asserts that this prejudice or bias caused the Deregulation Committee to act without due regard for the "safety and soundness" of savings and loans.³⁶⁹

This assertion fails to recognize the study conducted by the Deregulation Committee's staff in order to determine the effect of the reduction on savings and loans.³⁷⁰ Furthermore, the Chairman of the Bank Board voted for the action taken. Some of these same people determined the ceilings prior to the existence of the Deregulation Committee. No such claims were made when actions to reduce the differential were taken in 1977.³⁷¹

Count five asserts that the minimum ceiling promulgated by the Deregulation Committee causes the Money Market Certificates to exceed the prevailing market rates for deposit in certain circumstances.³⁷² This violates section 204(b) which prohibits the increase of limits on maximum rates above market rates during the phase-out.³⁷³

The Government's response is, in effect, "no harm, no foul." They state that since the minimum ceilings (7.75%)³⁷⁴ were applicable at the time of filing, no harm has yet been done. The Deregulation Committee's position is that "market rate" is not defined by the Act and that Treasury Securities are often less than market rates.³⁷⁵ The rationale behind the minimum ceiling is to allow rates comparable to those of Money Market Mutual Funds.³⁷⁶ This high ceiling would also give the depository institu-

³⁶⁶ Memorandum of Defendant at 8.

³⁶⁷ *Id.*

³⁶⁸ *Id.* at 25.

³⁶⁹ Complaint of Plaintiff at 17-18.

³⁷⁰ Memorandum of Defendant at 8.

³⁷¹ 42 Fed. Reg. 20,284 (1977) (codified at 12 C.F.R. § 217.7(e)); 42 Fed. Reg. 21,272 (1977) (codified at 12 C.F.R. § 329.6(b)(4) and § 329.7(b)(6)).

³⁷² Complaint of Plaintiff at 18-20.

³⁷³ 1980 Act *supra* note 3, at Title II, § 204(b) (to be codified at 12 U.S.C. § 3503(b)).

³⁷⁴ 45 Fed. Reg. 37,803 (1980) (to be codified at 12 C.F.R. § 1204.104).

³⁷⁵ Memorandum of Defendant at 20.

³⁷⁶ *Id.* at 24.

tions an opportunity to operate in an unregulated situation like that which will exist after phase-out with the security of a minimum ceiling.³⁷⁷

Although well intentioned, this ignores the fact that the Deregulation Committee itself has used the Treasury Securities to set the rates on these certificates so that almost by incorporation it has been used as the market rate. If the Treasury Securities are not the market rate, however, then why are the Certificates allowed to reach market level part of the time but unable to do so at other times? A better system might be to peg the rates of the Certificates to a more accurate gauge of the market rate. Lastly, the Deregulation Committee has set up a situation where the Treasury Securities rate may cause the minimum ceiling to go into effect at a time when the market rate would be less than the ceiling. This is a situation that the Act was intending to prevent during the phase-out.³⁷⁸

The sixth count asserts that the removal of the differential on I.R.A. and Keogh accounts was a violation of section 102(a) of Public Law 94-200.³⁷⁹ The Deregulation Committee has not acted on either of these accounts. The agencies that did act on them are not named as parties in this suit.³⁸⁰ Therefore, this count fails to state a claim on which relief can be granted. It seems as though any such claim should have been brought at the time of the offending action.

Furthermore, the U.S. League has failed to exhaust its administrative remedies available through the Deregulations Committee. The possibility of the Deregulation Committee reinstating these differentials has been circumvented by the failure of the U.S. League to seek relief from the Deregulation Committee. Considering the discretion given the Deregulation Committee this would be within their authority.³⁸¹ This failure violates a long-settled principle that in order to seek relief through the courts, administrative remedies must first have been exhausted.³⁸²

The seventh count is a catch-all constitutional claim that Title II not only denies savings and loans equal protection under the law but also due process of law and is, therefore, unconstitutional per se due to the composition of the Deregulation Committee.³⁸³ Count eight is related in that it is maintained that there is a violation of the fifth amendment.³⁸⁴

³⁷⁷ *Id.* at 11.

³⁷⁸ 1980 Act *supra* note 3, at Title II, § 204(b) (to be codified at 12 U.S.C. § 3503(b)).

³⁷⁹ Complaint of Plaintiff at 20-33.

³⁸⁰ The agencies involved were the FDIC and the Federal Reserve. This was accomplished in 1977 at 42 Fed. Reg. 20,284 (1977) (Fed. Reserve) and 42 Fed. Reg. 21,272 (1977) (FDIC).

³⁸¹ 1980 Act *supra* note 3, at Title II, § 204 (to be codified at 12 U.S.C. § 3503).

³⁸² *Meyers v. Bethlehem Shipbuilding Corp.*, 303 U.S. 41 at 50-51 (1938); *Weinberger v. Bentex Pharmaceuticals*, 412 U.S. 645 at 652 (1973); *Renegotiation Board v. Bannerkraft Co.*, 415 U.S. 1 at 24 (1974).

³⁸³ *Complaint of Plaintiff at 21-22.* ³⁸⁴ *Id.* at 22-24.

In addition, the U.S. League asserts that due to its composition, the Deregulation Committee has a built-in bias.³⁸⁵ With this bias there is a conflict of interest, for the Deregulation Committee is without specific and binding standards to follow in Title II.³⁸⁶ The eighth count's gravamen is that the actions were committed without submission of the annual reports to Congress required under section 206. By taking this action it is asserted that the Deregulation Committee violated the fifth amendment.³⁸⁷ The U.S. League bases both complaints on the fact that it has only one thrift representative on the Deregulation Committee and that that representative is the only member concerned with home financing.

These assertions fail to recognize that administrative rulemakers as individuals are presumed to have conscience and intellectual discipline, capable of judging a particular controversy fairly on the basis of its own circumstances.³⁸⁸ This must be refuted before a court will find that bias existed.³⁸⁹

The composition of the Deregulation Committee includes the National Credit Union Administration which regulates thrifts.³⁹⁰ The F.D.I.C. as well regulates mutual savings banks which are thrifts. In the area of home financing the savings and loans are not alone. Small commercial banks are also mortgage lenders. The composition of the Deregulation Committee may, consistent with the requirement of due process, contain members already familiar with the facts of particular cases.³⁹¹ The composition of an administrative tribunal does not violate equal protection merely because it can be shown to be unsympathetic to a particular minority position.³⁹² Furthermore, the makeup of the Committee was set by Congress, which has a legitimate interest in the regulation of financial institutions.

In count nine the U.S. League asserts that the Deregulation Committee failed to follow the Administrative Procedure Act (hereinafter A.P.A.).³⁹³ The asserted violations of the A.P.A. were: adopting the regulations without giving public notice and comment time and not delaying the effective date of the regulations for at least 30 days.³⁹⁴

³⁸⁵ *Id.* at 23.

³⁸⁶ 1980 Act *supra* note 3, at Title II, § 205(b) (to be codified at 12 U.S.C. § 3504(b) (1980)).

³⁸⁷ Complaint of Plaintiff at 23.

³⁸⁸ 313 U.S. 409 at 421 (1941).

³⁸⁹ 333 U.S. 683 at 701 (1948), cited in *Hortonville Joint School District No. 1 v. Hortonville Education Ass'n*, 426 U.S. 482 at 493 (1976).

³⁹⁰ 12 U.S.C. § 1752(1) defines the term Federal Credit Union as "a cooperative association organized . . . for the purpose of promoting its members."

³⁹¹ 426 U.S. 482 at 493: "Mere familiarity with the facts of a case . . . does not disqualify a decision maker."

³⁹² *Friedman v. Rogers*, 440 U.S. 1 at 18 (1979).

³⁹³ Complaint of Plaintiff at 24-26. The text of the A.P.A. is found at 5 U.S.C. § 551 *et. seq.* (1976).

³⁹⁴ These provisions are found at 5 U.S.C. § 553(b) and (c) (1976).

The requirement of advance notice and public comment time can be waived³⁹⁵ when the agency, for good cause, finds that notice and public procedure are impractical, unnecessary or contrary to the public interest.³⁹⁶

During April and May of 1980 the interest rates were falling. The Deregulation Committee staff's study showed that depositors were pulling out of the depository institutions and going to non-depository institutions. The staff study also showed that the reinstitution of the differential for commercial banks would do even more harm to them, for anyone wanting to stay in the depository institutions would go to the thrifts. This would be especially hard on the small commercial banks that have relied heavily on the Money Market Certificates. These small commercial banks are primarily in the business of making agricultural and small business loans to persons or entities which have few alternative loan sources.³⁹⁷ The thrifts would also be hurt by the declining interest rates because depositors would withdraw from thrifts as well as commercial banks which, in turn, would cause home financing to be restricted.³⁹⁸

The Deregulation Committee acted in the same fashion as did its predecessors in promulgating changes in interest rates. When these agencies originally adopted maximum rates on Money Market Certificates they did not use notice and comment procedures.³⁹⁹ This is also the case in the adoption of Small Saver Certificates.⁴⁰⁰ When the rates on Money Market Certificates were modified, the same procedure was followed.⁴⁰¹ As a result, this procedure has been used often without being questioned.

The Deregulation Committee did not delay the effective date of the new ceilings for 30 days for two reasons. The first was that an economic emergency was likely to take place in the depository institutions, especially the small commercial banks. The Deregulation Committee feared that the 30 day delay would cause harmful disruptions in the financial community.⁴⁰² The second reason was the fear that speculation on these Certificates would take place. Depositors might hold back on purchases of Certificates until the new rates were in effect. This would cause a drain on funds in depository institutions and restrict their loan making ability.⁴⁰³

The tenth count repeats the ninth count, wherein the League cites

³⁹⁵ The requirement of publishing new regulations 30 days before the effective date can be waived under 5 U.S.C. § 553(d)(3) (1976).

³⁹⁶ *Id.* at (b)(3)(B).

³⁹⁷ Memorandum of Defendant at 28.

³⁹⁸ *Id.* at 27.

³⁹⁹ 43 Fed. Reg. 21,435 (1978).

⁴⁰⁰ 44 Fed. Reg. 75,621 (1979); 44 Fed. Reg. 75,378 (1979); 44 Fed. Reg. 75,625 (1979).

⁴⁰¹ 44 Fed. Reg. 16,360 (1979); 44 Fed. Reg. 15,476 (1979).

⁴⁰² Memorandum of Defendant at 29.

⁴⁰³ *Id.*

statutory language which reads: "The reviewing court shall hold unlawful and set aside agency action . . . found to be arbitrary, capricious, an abuse of discretion, authority or otherwise not in accordance with law."⁴⁰⁴ This was asserted for reasons set forth in counts one, two and five.

This count is thus based on the acceptance of assertions made in counts one, two and five. Under this analysis, only count five has shown any violation of the Act or the intent of Congress.⁴⁰⁵ Nowhere in the Deregulation Committee's promulgation are there arbitrary or capricious acts, abuse of discretion or statutory excesses. The Deregulation Committee was given great discretion in setting rates as well as when to set them. Their staff studied the problems necessitating the need for these actions. There were three meetings held before the Committee went forward. The rationale behind their promulgation is within the limitations of the intent of Congress in passing the statute.⁴⁰⁶ The only failure of the Deregulation Committee is in the promulgation of minimum ceilings which may cause ceiling rates to go above the market rates, but even this was done with due deliberation and for sound reasons, not arbitrarily or capriciously.

Count eleven asserts that the Deregulation Committee was arbitrary, capricious, abused its discretion and did not act in accordance with the law in promulgating the new ceilings because of the bias or prejudice of certain members against the differential and/or savings and loans (count four).

There is no showing that those Committee members who are named acted with intent to harm the savings and loans. Moreover, if these regulators are biased toward the depository institutions under their respective agencies, no showing has been made that the promulgations were not with the safety and soundness of the depository institutions in mind. Absent this showing, these actions are within the mandate of Congress.

The major failure of the Deregulation Committee in these promulgations is to set the minimum ceiling on the Certificates which go against the intent of the Act by creating a situation where rate ceilings may exceed market rates. The other actions of the Deregulation Committee are within the intent of the Act and in accordance with the A.P.A.

E. Conclusion

The Deregulation Committee appears, from the action taken so far, to be aggressively carrying out the authority given it in Title II of P.L. 96-221. If the Deregulation Committee is not thwarted in its attempts to carry out deregulation by this case, deregulation should and will come to financial

⁴⁰⁴ 5 U.S.C. § 706(2)(A) (1976).

⁴⁰⁵ See text accompanying notes 372-378, *infra*.

⁴⁰⁶ See 1980 Act *supra* note 3, at Title II, § 205, 12 U.S.C. § 3504 (1980).

institutions before the end of the six years unless the market conditions change so radically as to make this course unwise and/or politically unpopular.

The cost of regulation to the consumer is the theme of the day and the business community has complained about regulations every chance it gets. Now a government agency is attempting to take the regulations off the collective back of financial institutions and cut the cost to consumers and a part of the financial institution industry (the thrifts) scream murder. However, the future is likely to hold more deregulation in this area, with true competition setting in. The thrifts had better be prepared because the evidence of the desire for quick action can be seen by the change in Certificate Regulations taken by the Deregulation Committee. If the case is decided in favor of the Deregulation Committee, as it should be, then it should be an interesting and competitive next couple of years.

TITLE III: THE CONSUMER CHECKING ACCOUNT EQUITY ACT OF 1980

Introduction

Title III of the Depository Institutions Deregulation and Monetary Control Act of 1980⁴⁰⁷ is more commonly known as the Consumer Checking Account Equity Act of 1980.⁴⁰⁸ Its basis for noteworthiness to the consumer centers on its authorization of the Negotiable Order or Withdrawal or NOW account and the credit union corollary share draft program. These accounts allow thrift institutions, banks, and credit unions to offer consumers the "functional equivalent of interest bearing checking accounts."⁴⁰⁹ Although, at first glance, this type of interest authorization may seem to be a simple development that would work to the benefit of any consumer, there are many intricacies in this title that are worthy of discussion. This section of this comment will discuss the background and development of the Act, its impact upon the consumer, its impact on banking institutions and credit unions, its relationship to negotiable instruments law in Article III of the Uniform Commercial Code, and its future as a basis for litigation.

A. *Background and Development*

The banking system in operation today is a result of the United States Supreme Court holding in *McCulloch v. Maryland*.⁴¹⁰ That Court upheld the authority of Congress to charter banks under the "necessary and proper" clause of Article I of the United States Constitution. This is in addition to "the histo-

⁴⁰⁷ 1980 Act, *supra* note 3.

⁴⁰⁸ *Id.* at § 302.

⁴⁰⁹ S. REP. NO. 96-368, 96th Cong., 2d Sess. 1 (1980) reprinted in [1980] U.S. CODE CONG. & AD. NEWS 834, 835.

⁴¹⁰ 4 Wheat. (U.S.) 316 (1819).

rical regulation of banks by states, reserved to them as a police power under the Constitution."⁴¹¹ Therefore, there are financial institutions chartered by both Congress and the states.

District Court Judge Bownes discussed extensively the three types of federally chartered financial institutions. The first of these is national associations or national banks, which are primarily commercial banks.⁴¹² Commercial banks traditionally could accept both time⁴¹³ and demand⁴¹⁴ deposits, and, in addition, they offered certificates of deposit.⁴¹⁵ Second, there are federal savings and loan associations⁴¹⁶ which were formed by Congress. "[I]n order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes."⁴¹⁷ Prior to the advent of the NOW account, funds in these savings and loan association accounts could not be withdrawn through the use of a check or negotiable order. Finally, in 1934, the Federal Credit Union Act authorized the creation of the third type of federally chartered institution, federal credit unions.⁴¹⁸ The principal difference between the credit union and other federally authorized financial institutions is the democratic control and management mandated in the credit union. Credit unions may only accept deposits and make loans to their members. Prior to the Consumer Checking Account Equity Act,⁴¹⁹ they could not offer any type of checking account. The impact of the 1980 Act on each of these institutions will be discussed in detail in this section.

NOW accounts made their first appearance in the state of Massachusetts⁴²⁰ and their validity was upheld by the Massachusetts Supreme Judicial

⁴¹¹ *La Caisse Populaire Ste- Marie (St. Mary's Bank) v. States*, 425 F. Supp. 513 (D. N.H., 1976) at 515. See also the authorities cited by District Judge Bownes at 425 F. Supp. 515.

⁴¹² These banks have the option of becoming members of the Federal Reserve. As stated by Judge Bownes: "All national Banks are subject to the rules of the Comptroller of the Currency, an official of the Treasury Department, and all must have their deposits insured by the Federal Deposit Insurance Corporation. See generally 12 U.S.C., chs. 1, 2, 3, & 16 National banks are permitted to form branches pursuant to state law. 12 U.S.C. § 36. . . . Traditionally, national banks . . . have favored short- term loans, although are permitted and do maintain a smaller percentage of their assets in consumer loans, real estate loans, and others."

St. Mary's Bank, 425 F. Supp. at 516.

⁴¹³ Time deposits are those that cannot be legally required to be paid until a certain day or time or for a certain period after the deposit is made. An example is a savings account. 12 C.F.R. § 217.1(6) (1980).

⁴¹⁴ Demand deposits, for example a checking account, are payable on demand. 12 C.F.R. § 217.1(a) (1980).

⁴¹⁵ Certificates of deposit are long term, high yield deposits. 12 C.F.R. § 217.1(c) (1980).

⁴¹⁶ In 1933 the Home Owners' Loan Act (12 U.S.C. § 1461 et. seq.) established the Federal Home Loan Bank Board. Under this Act, that Board was given the authority to charter and supervise these savings and loan associations. 12 U.S.C. § 1464 (1976).

⁴¹⁷ 12 C.F.R. § 545.4-1(a)(1) (1980).

⁴¹⁸ 12 U.S.C. §§ 1751-1770 (1976).

⁴¹⁹ 1980 Act, *supra* note 3, Title III.

⁴²⁰ *Mass. GEN. LAWS ANN. ch. 168, § 26* (West, 1981).

Court in 1972.⁴²¹ That Court held that a savings bank "is entitled to permit its depositors to make withdrawals by means of a withdrawal order in negotiable form."⁴²²

Although that Court cleared the way for savings banks to offer NOW accounts, commercial banks, savings and loan associations, and cooperative banks were prohibited from offering similar accounts. This created a great deal of controversy, especially as NOW accounts spread into the state of New Hampshire as well as Massachusetts.⁴²³

Finally, in 1973, the Congress took a position on the operation of these NOW accounts. At that time Congress allowed depository institutions in Massachusetts and New Hampshire only to offer accounts, withdrawals from which could be made by the use of a negotiable instrument, and receive interest.⁴²⁴ The Act also imposed sanctions upon any institution outside these two states that offered such accounts.⁴²⁵ This served to clear the controversy in allowing all Massachusetts and New Hampshire banks, but no others, to offer NOW accounts. In enacting section 2, Congress apparently decided "to permit continuance of NOW accounts on a limited experimental basis."⁴²⁶

But NOW accounts continued to spread. In 1976, authorization for NOW accounts was extended to the remaining New England states of Connecticut, Maine, Rhode Island, and Vermont.⁴²⁷ As noted by Irvine H. Sprague, Chairman of the Federal Deposit Insurance Corporation (FDIC):

⁴²¹ *Consumer Savings Bank v. Commissioner of Banks*, 361 Mass. 717, 282 N.E.2d 416 (1972).

⁴²² *Id.* at 719, 282 N.E.2d 417-18.

⁴²³ Kaplan, *Federal Legislative and Regulatory Treatment of NOW Accounts*, 91 *BANKING L.J.* 439 (May, 1974).

⁴²⁴ Pub. L. No. 93-100, 87 Stat. 342 (Aug. 3, 1973). Section 2(a) of this Act reads as follows:

"No depository institution shall allow the owner of a deposit or account on which interest or dividends are paid to make withdrawals by negotiable or transferable instruments for the purpose of making transfers to third parties, except that such withdrawals may be made in the States of Massachusetts and New Hampshire."

Section 2(b) defined depository institution as:

"(1) any insured bank as defined in section 3 in the Federal Deposit Insurance Act;
 "(2) any State bank as defined in section 3 of the Federal Deposit Insurance Act;
 "(3) any mutual savings banks as defined in section 3 of the Federal Deposit Insurance Act;
 "(4) any savings bank as defined in section 3 of the Federal Deposit Insurance Act;
 "(5) any insured institution as defined in section 401 of the National Housing Act;
 "(6) any building and loan association or savings and loan association organized and operated according to the laws of the State in which it is chartered or organized; and for purposes of this paragraph, the term 'State' means any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands."

⁴²⁵ "Any depository institution which violates this section shall be fined \$1,000 for each violation." *Id.* at § 2(c).

⁴²⁶ Kaplan, *supra* note 423, at 442.

⁴²⁷ Pub. L. No. 94-222, § 2, 10 Stat. 197 (Feb. 27, 1976).

"In many respects, the initial phase of the NOW account availability resembled the *current* rather than the first-year NOW account experience in Massachusetts and New Hampshire. For example, commercial banks immediately emerged as the dominant NOW account force in the four states, accounting for 82 percent of total balances in NOWs. Moreover, by June 1978, 52 percent of the commercials and 55 percent of the thrifts in the four states offered NOW accounts, which is like the current situation in Massachusetts and New Hampshire rather than the initial experience."⁴²⁸

Soon after, in November of 1978, New York banks were given authority to offer Automatic Transfer Services which resembles the NOW account in many ways.⁴²⁹ The Congress then proceeded to authorize NOW accounts in New York in that same month.⁴³⁰

The impetus for the extension of NOW accounts nationwide, however, developed in Washington, D.C. in 1978. At that time two cases arose in the United States District Court for the District of Columbia that served to speed up a decision on whether or not NOW accounts had a viable future in the United States. The first of these was *United States League of Savings Associations v. Board of Governors of the Federal Reserve System*.⁴³¹ This was an action brought by the United States League of Savings Associations (hereinafter the League) challenging regulations of the Board of Governors of the Federal Reserve System. On May 1, 1978, the Board had amended section 217.5(c) of its Regulation Q to allow automatic fund transfer (AFT) service⁴³² to allow the depositor to use moneys from his savings account to cover overdrafts or maintain a certain balance in that depositor's checking account.⁴³³ There were several reasons for the challenge to the authorization of the AFT services by the League. First, it was alleged that these regulations, if allowed to take effect, would violate the statutory

⁴²⁸ *The Consumer Checking Account Equity Act of 1979, Hearings on H.R. 3864 Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 96th Cong., 1st Sess. 81 (1979) (Statement of Irvine H. Sprague). [Hereinafter referred to as *Hearings on H.R. 3864*].

⁴²⁹ [1980] U.S. CODE CONG. & AD. NEWS 843. Automatic Transfer Services [hereinafter ATS] permit withdrawals to be made automatically from an interest bearing savings account into a demand deposit account pursuant to a written agreement by the depositor, and allows the depositor to make payments by checks or drafts even if the amount necessary to cover that instrument is not available directly from the checking account. *Hearings on H.R. 3864*, *supra* note 428, at 84 (Statement of Irvine H. Sprague).

⁴³⁰ Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, 92 Stat. 3641 (Nov. 10, 1978).

⁴³¹ 463 F. Supp. 342 (D.C.D.C., 1978).

⁴³² 43 Fed. Reg. 20,002 (1978) (codified at 12 C.F.R. § 217.5(c)(2) (1980)). This is substantially the equivalent to the ATS.

⁴³³ The FDIC, which regulates all federally insured commercial banks that are not members of the Federal Reserve System, adopted a similar rule on May 5, 1978, at 43 Fed. Reg. 20,223 (1978) (codified at 12 C.F.R. § 329.5(c)(2) (1980)). Both were scheduled to take effect on November 1, 1978. 463 F. Supp. at 344.

provisions against the payment of interest on demand deposits.⁴³⁴ Since the funds needed to cover a check could remain in the interest bearing savings account until needed to cover a check, this would allow the depositor to maintain a zero balance on the checking account with the funds transferring over each time a check was written. This would cause the AFT service to be, for all practical purposes, the equivalent of the NOW account. The checking account would become a mere conduit between the savings account and the payee named in the check. As such, these regulations would violate the statutory prohibition of the withdrawal, by the use of negotiable instruments, of the funds from a interest bearing savings account.⁴³⁵ The League alleged that this would cause economic injury to existing savings and loan associations. The District Court rejected the League's argument, noting:

" . . . [A]utomatic fund transfer regulations do not violate the statutory prohibition against the payment of interest on demand deposits or against negotiable instruments drawn on savings deposits. This result is supported by the convenience and other benefits AFT services will produce for bank customers and the role such services will play in reducing the number of checks returned for insufficient funds."⁴³⁶

The second case, *American Bankers Association v. Connell*,⁴³⁷ concerned the authorization of share draft programs. The Bankers Association challenged the statutory authority of such programs to be offered under the Federal Credit Union Act.⁴³⁸ The Court, however, allowed these programs to continue, holding: "that share draft practices are among the incidental powers of [Federal Credit Unions and] is not inconsistent with the legislative history of the FCU Act or general Congressional scheme controlling federal financial institutions."⁴³⁹

The support to the AFT services and share draft programs by the courts was short lived. On April 20, 1979, the Court of Appeals for the District of Columbia reversed both decisions and refused to allow regulatory

⁴³⁴ 12 U.S.C. § 371a (1976), see also 463 F. Supp. at 345.

⁴³⁵ Then 12 U.S.C. § 1832(a) (1976), as enacted in Pub. L. 94-222, § 2, 90 Stat. 197. (since amended by § 303 of the 1980 Act, *supra* note 3).

⁴³⁶ 463 F. Supp. at 352.

⁴³⁷ 477 F. Supp. 296 (D.C.D.C., 1978).

⁴³⁸ 447 F. Supp. at 297-298, notes:

"A share draft is a demand draft which is drawn by a member on his credit union share account and which is made payable to third parties. Each share draft is payable through a particular commercial bank . . . Share drafts are similar in appearance to checks . . ."

⁴³⁹ 447 F. Supp. at 299. The "incidental powers" referred to by the Court are found in 12 U.S.C. § 1757(15) (1976), which grants federal credit unions the authority "to exercise such incidental powers as shall be necessary to carry on the business for which [federal credit unions are] incorporated."

agencies to authorize any such programs.⁴⁴⁰ That Court tempered its order by the following language: "The effectiveness of this judgment, insofar as it directs the subject regulations be vacated and set aside, is stayed until 1 January 1980, in the expectation that Congress will declare its will upon these matters."⁴⁴¹ This decision served to spur the Congress into action if it wanted to save the services in question. The House of Representatives immediately began work on a bill that would allow financial institutions to offer interest bearing checking services. A bill of this type was originally passed by the House in September, 1979.⁴⁴²

In November, the Senate passed the measure and added a provision to phase out interest rate ceilings and another to provide new lending powers to savings institutions. The House, in turn, added provisions that dealt with the Federal Reserve membership and reserve requirements. They extended the court-set deadline of January 1 to March 31, 1980, when an immediate agreement could not be reached on all of the provisions.⁴⁴³ Finally, on March 5, 1980 all differences were ironed out. The bill was signed into law by President Carter on March 31, 1980.

"At a White House signing ceremony, Carter called the legislation 'a significant step in reducing inflation' and a 'major victory' for Savers. Treasury Secretary G. William Miller described the bill as the 'most important legislation dealing with banking and finance in nearly half a century.'"⁴⁴⁴

A synopsis of the major provisions of Title III of the 1980 Act follows. Section 302 allows withdrawals to be made automatically from a savings deposit that consists only of funds in which the entire beneficial interest is held by one or more individuals through payment to bank itself or through transfer of credit to a demand deposit or other account pursuant to written authorization by the depositor.⁴⁴⁵ Section 303 authorizes NOW accounts but limits their use to individuals and non-profit organizations.⁴⁴⁶ Section 304 permits the use of remote service units "for the purpose of crediting savings accounts, debiting such accounts, crediting payments on loans, and the disposition of related financial transactions."⁴⁴⁷ Share draft programs are authorized for individuals and non-profit organizations through credit

⁴⁴⁰ United States League of Savings Associations v. Board of Governors of the Federal Reserve System, 595 F.2d 887 (D.C. Cir., 1979) (447 F. Supp. 296 and 463 F. Supp. 342, *vacated and set aside*).

⁴⁴¹ S. REP. No. 96-368, 96th Cong., 2d Sess. 6 (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 839.

⁴⁴² See 1980 House Reg. Q. Hearings, *supra* note 2, at 4.

⁴⁴³ Automatic Transfer Accounts, Pub. L. No. 96-161, 93 Stat. 1233.

⁴⁴⁴ 38 Cong. Q. 964 (weekly ed. April 12, 1980).

⁴⁴⁵ 1980 Act, *supra* note 3, at § 302(a).

⁴⁴⁶ *Id.* at § 303.

⁴⁴⁷ *Id.* at § 304.

unions by section 305.⁴⁴⁸ All prior sections became effective March 31, 1980 except section 303 authorizing NOW accounts which became effective on December 31, 1980.⁴⁴⁹ Section 308 of Title III increased the federal deposit insurance limit from \$40,000 to \$100,000 in each insured deposit institution.⁴⁵⁰ This increase was effective March 31, 1980, and applied to insured national and state chartered commercial banks as well as all the federally insured savings and loan associations and credit unions. In addition, the amount of interest permitted to be charged by credit unions on their loans was increased from twelve to fifteen percent.⁴⁵¹

B. *Impact of NOW Accounts on the Consumer*

Upon the passage of the Consumer Checking Account Equity Act of 1980, the financial institutions wasted no time in bombarding the consumer market with advertisements encouraging consumers to take advantage of their newly authorized offerings. These advertisements tell the consumer that 5.25% interest is available on checking accounts and seem to leave the consumer wondering who would possibly refuse the chance to earn some "free money." As much as this interest bearing NOW account may benefit many consumers, it is important to note that there may be instances when a consumer could benefit most by retaining his traditional savings and checking account.

Most banks offering NOW accounts require that a minimum balance be kept in the account to avoid service fees. If the balance of the account dips below this minimum, a monthly charge as well as a per check fee may be charged. In fact,

"Many people if they maintain a low balance and write a lot of checks, will find at the end of the year that they have lost money on NOW accounts. After reading all this hype from the financial institutions about what a bonanza NOW accounts are, they will feel cheated, because at the beginning of the year they weren't given the opportunity to sit down and figure out how much the NOW account was going to cost them."⁴⁵²

As a result of the possibility of this type of situation, most financial institutions have made disclosures as to amount of interest offered as well as minimum balances needed to be maintained and service fees to which the NOW account may be subject. The consumer should consider all of these

⁴⁴⁸ *Id.* at § 305.

⁴⁴⁹ *Id.* at § 306.

⁴⁵⁰ *Id.* at § 308.

⁴⁵¹ Title III only authorized such an increase for periods not to exceed eighteen months, *Id.* at § 310. The National Credit Union Administration exercised this power by increasing the interest rate to 15 percent on March 31, 1980. 45 Fed. Reg. 22,888 (1980) (to be codified at 12 C.F.R. §§ 701.21-1, 701.21-3, 701.21-6).

⁴⁵² *Hearings on H.R. 3864, supra* note 428, at 216 (Discussion Statement of Ellen Broadman).

factors carefully in considering what the NOW account has to offer him as an individual. Only by such close scrutiny by the banking public can NOW accounts serve all to their best ability.

As a whole, the result of the passage of the 1980 Act should greatly benefit the consumer. In addressing the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Chairman St. Germain indeed emphasized the Congressional intent to benefit the consumer, giving as the purpose of the bill in question "to provide the consumer access to a simple interest bearing checking account."⁴⁵³ In addition, since NOW accounts are optional, it would seem that the consumer has nothing to lose since he may retain the traditional system of banking that he had always had if he so desires. From the New England experience, however, it is clear that the consumer has great enthusiasm for NOW accounts.⁴⁵⁴

The principal differences between a NOW account and the traditional checking account may be described as follows:

- "(1) NOW accounts are available to personal depositors, sole proprietorships, and charitable public units, whereas demand accounts are available to all individuals and organizations.
- "(2) NOW accounts are technically savings deposit accounts, not demand deposit accounts, and therefore,
- "(3) interest may be paid on balances maintained in the NOW account, which is prohibited by statute from being paid on demand accounts, and
- "(4) drafts withdrawing funds from NOW accounts may be legally delayed for thirty days, which is not the case for checks."⁴⁵⁵

The advantages to the consumer are the ability to gain interest on demand deposits, the ability to have all banking at one location or even in one account, and a reduced chance of checks being returned for insufficient funds.

The dangers of the NOW account have been expressed as well. Congressman Wylie expressed the following fear:

⁴⁵³ *Id.*, at 1.

⁴⁵⁴ *Id.* at 60-61 (Statement of John G. Heimann). Mr. Heimann as Comptroller of the Currency notes consumer enthusiasm, saying:

"... at the close of 1978, just two months after the automatic fund transfer service was initiated about 5,000 commercial banks held \$3.3 billion in 420,000 accounts. As of April 25, 1979, total automatic transfer account balances had increased to \$6.4 billion. At the close of 1978, there were about 800,000 share draft accounts totaling \$720 million in approximately 740 federal credit unions. In addition, there were an estimated 400,000 share draft accounts in 600 state credit unions. About 200 Federally chartered savings and loan associations have been approved by the [Federal Home Loan Bank Board] to operate remote service units. These units have access to \$2.6 billion in savings deposits. During 1978, an estimated 2.25 million transactions occurred through remote service units with a total of \$172 million being transferred."

⁴⁵⁵ *Id.* at 84 (Statement of Irvine H. Sprague).

"The cost of paying interest on NOW accounts, it seems to me, has to be passed on to somebody and that somebody is the consumer. So I cannot see how the NOW account would benefit the person who is seeking the money for his house or seeking money for loans because as I see it, if interest is paid on NOW accounts to obtain money for lending purposes the cost will be passed on."⁴⁵⁶

Finally, the fear has been expressed that the effect of the Depository Institutions Deregulation and Monetary Act of 1980 as a whole will be to take moneys away from savings and loan associations which are primary lenders for housing purposes. With the addition of the possibility that these savings and loan associations could invest their funds elsewhere, the possibility of less funds available for housing with higher interest rates may become a reality.⁴⁵⁷

C. *Impact of NOW Account Legislation on the Banking Industry*

The legislation permitting NOW accounts⁴⁵⁸ serves to blur many of the distinctions between national or commercial banks⁴⁵⁹ and savings and loan associations or thrift institutions which were created primarily for the small saver and to provide home financing. In fact, "all the distinctions between commercial banks and thrifts will become increasingly muddled as a result of the 1980 legislation."⁴⁶⁰ This is true since savings and loan associations may now offer the use of negotiable instruments as a means of withdrawal from a savings account. The commercial bank may now offer interest on those checking accounts converted to NOW accounts by customer authorization.⁴⁶¹

As a result of these developing similarities, a great deal of competition between depository institutions should become apparent. This competition will become even more intense about the middle of the decade when interest rate ceilings are eliminated.⁴⁶² For example, "George M. Salem, ana-

⁴⁵⁶ *Id.* at 11. A similar concern was expressed in an article entitled "America's New Financial Structure-Fewer but Bigger Institutions-Is the Small Bank an Endangered Species?" *BUSINESS WEEK*, November 17, 1980 at 140. That article notes:

"Once cheap consumer deposits are going to become more expensive and precious for depository institutions to maintain as the bidding war for such deposits heats up. To compensate, institutions have to price NOWs sufficiently high to avoid losing money on the product. Most will require minimum balances and impose usage or per-check charges."

⁴⁵⁷ *BUSINESS WEEK*, November 17, 1980 at 141.

⁴⁵⁸ 1980 Act, *supra* note 3, at § 303.

⁴⁵⁹ See generally 1980 Act, *supra* note 3, at § 302, 303.

⁴⁶⁰ *BUSINESS WEEK*, November 17, 1980 at 141-142.

⁴⁶¹ These accounts are subject to a notice requirement and a bank may not be legally forced to pay the instrument until a set period after the demand for payment is made. Although savings and loans and commercial banks seldom, if ever, enforce this notice requirement, it is still a possibility. *Hearings on H.R. 3864, supra* note 428, at 77 (Statement of Irvine H. Sprague).

⁴⁶² Assuming the target dates set at § 205 of the 1980 Act are met - see text accompanying fn. 304-314, *supra*.

lyst at Bache Halsey Stuart Shields Inc., notes . . . 'one of the largest competitive battles in the history of banking is about to begin.'⁴⁶³ As a part of this competition, some large banks may be willing to initially treat NOW accounts as loss leaders.⁴⁶⁴ Smaller institutions may feel the pinch and be forced to match the larger institution or watch their deposits drain away.⁴⁶⁵ In addition, the large banking organizations may move into new areas in search of new deposits and customers.⁴⁶⁶ For all banking institutions in general, "once cheap consumer deposits are going to become more expensive and precious for depository institutions to maintain as the bidding war for such deposits heats up."⁴⁶⁷ The competition would seem to reflect the desire to allow the market to dictate the type of accounts offered and their prices.⁴⁶⁸

This type of competition may stem from other effects of NOW accounts on the banking system. NOW accounts are very attractive to typical customers including those who now use checking accounts in a commercial bank. The commercial bank may foresee the "likelihood of their customers being 'lured' to the savings banks by these attractive new services. On the other hand, savings banks contend that they are not attempting to upset the competitive balance, but are merely trying to provide their own customers with a service they desire to have."⁴⁶⁹ The commercial banks still have some customer base that will be left untouched, that being corporate business, to whom the NOW account is unavailable.⁴⁷⁰ What will affect the customer's decision of where to bank, however, is the availability of one stop banking⁴⁷¹ as well as the availability of newly authorized remote service units, many of which allow twenty-four hour service.

The thrift industry should find several advantages as a result of the new legislation. In these days when checking is a preferred method of doing business, the NOW account gives the thrift institution a means to compete with the commercial bank that was previously foreign to them. Some advantages to the thrifts include:

- "(1) The NOW account provides thrifts with an ability to compete more effectively in the short term savings and transactions account market.
- "(2) Thrifts in New England have increased their deposits and thereby can provide more funds for housing.

⁴⁶³ BUSINESS WEEK, November 17, 1980 at 141.

⁴⁶⁴ *Id.*

⁴⁶⁵ *Id.*, at 140.

⁴⁶⁶ *Id.*

⁴⁶⁷ *Id.* See also text accompanying fn. 449, *supra*.

⁴⁶⁸ *Hearings on H.R. 3864, supra* note 428 at 44-45.

⁴⁶⁹ 14 B.C. IND. & COM. L. REV. 471, 489 (Feb. 1973).

⁴⁷⁰ *Id.*, see also 1980 Act, *supra* note 3, § 303.

⁴⁷¹ 14 B.C. IND. & COM. L. REV. 490 (Feb. 1973).

"(3) Future industry growth will likely become increasingly dependent upon such innovations as increasing competition and innovation in financial markets erode the effectiveness of deposit rate ceilings and differentials. Future viability of thrift institutions may well depend upon an ability to provide the consumer with a diversity of financial services."⁴⁷²

These advantages may indeed be counterbalanced by the inexperience of the thrift institutions in dealing with this type of service and the expense in developing the equipment and personnel necessary for handling the NOW account.⁴⁷³

Transitional problems will also be something that depository institutions will have to deal with as they arise. These will most probably include the following:

"First, servicing transactions accounts requires a substantial investment in equipment and a large number of employees. This would require a major adjustment on the part of thrift institutions that decided to compete for transactions balances . . . Second, both commercial banks and thrift institutions have relatively little experience in pricing transactions services. [Such as remote service units and automatic funds transfer services.] . . . Third, allowing thrift institutions to offer transactions services will add a substantial number of suppliers of these services all at once. However, demand for transactions services is likely to change only gradually. Thrifts, as new entrants, are likely to follow strategies aimed at building market share, while commercial banks will follow strategies aimed at holding on to existing demand deposits."⁴⁷⁴

How the depository institutions handle these problems remains to be seen in the near future. This as well as the results of the competition between the banks will shape the course of American banking institutions as the effects of the market shape their course.

D. *Effect of the 1980 Legislation on Credit Unions*

Section 305 of the Consumer Account Equity Act of 1980 permits every insured credit union to "permit owners of such share draft accounts to make withdrawals by negotiable or transferrable instruments or other orders for the purpose of making transfers to third parties."⁴⁷⁵ Again, this type of service is available only to individuals and to non-profit organizations.⁴⁷⁶ These share draft accounts offer members of credit unions the op-

⁴⁷² *Hearings on H.R. 3864, supra* note 428, at 118-119 (Statement of Robert H. McKinney).

⁴⁷³ Guidelines for setting up the processes dealing with the collection and settlement of instruments drawn on such institutions have been set out by the Federal Home Loan Bank Board to help deal with this problem. 45 Fed. Reg. 64,161 (1980).

⁴⁷⁴ *Hearings on H.R. 3864, supra* note 428, at 63-63 (Statement of John G. Heimann).

⁴⁷⁵ 1980 Act, *supra* note 3, § 305(d) (to be codified at 12 U.S.C. 1785(f)(1)).

⁴⁷⁶ *Id.* (to be codified at 12 U.S.C. 1785(f)(2)).

portunity to earn interest on a savings type account and have access to these accounts through the use of draft instruments that are functionally the equivalent of checks.⁴⁷⁷

This type of share draft program was necessary and vital to the continued operation and growth of all credit unions in the United States. Since the passage of the Federal Credit Union Act in 1934, credit unions have enjoyed substantial growth and popularity as a result of advantages they have had over other financial institutions:

"These have included the convenience of credit union location and operation. Often, the credit union was the only financial institution located near a workplace that had operating hours dovetailing the consumers' working schedule. The ability to deduct share deposits and loan payments directly from an employee's paycheck has in the past been a significant—and in some cases unique—advantage credit unions have enjoyed over other financial institutions."⁴⁷⁸

With the dawn of modern banking conveniences such as the remote service unit, that often allows twenty-four hour availability of a bank to the consumer, these advantages are not so unique as they once were. In order to keep up with other financial institutions and consumer demands, the authorized share draft programs should greatly increase the attractiveness of the credit union to the consumer.

Credit unions are also expanding their abilities to serve their members by beginning a new remote service unit program that has recently been approved by the National Credit Union Administration.⁴⁷⁹ These units are being set up under the authority conferred to the Administration under the Federal Credit Union Act⁴⁸⁰ which gives credit unions incidental powers to help them carry out their business efficiently. Included in the authorization of these programs are guidelines to setting up and operating these units.

In summary, the 1980 Act greatly increases the ability of credit unions to serve their members. Although adjustments may be necessary in adapting their business to meet new membership needs, these changes brought about by the Act will increase credit union services and make them an even more competitive force in the financial market.

E. *Relationship Between NOW Account Legislation and Article III of the Uniform Commercial Code*

The withdrawal instruments authorized under the Consumer Checking Account Equity Act of 1980 is a negotiable instrument, having met all the re-

⁴⁷⁷ U.C.C. § 3-104(2)(a), which defines a draft as a negotiable instrument that is an order.

⁴⁷⁸ *Hearings on H.R. 3864, supra* note 428, at 239 (Statement of Roy Hollihan).

⁴⁷⁹ 45 Fed. Reg. 32,290 (May 16, 1980).

⁴⁸⁰ 12 U.S.C. 175 (15) (1976).

quirements of such as set out in the Uniform Commercial Code.⁴⁸¹ The withdrawal instrument must be signed by the maker who would be the depositor, and it is an unconditional promise to pay a sum certain in money which is payable on demand to order or bearer. As such, it is subject to the provisions of Article III of the U.C.C. which deals with commercial paper.

It is fairly clear that the NOW instrument will be treated the same as any check or draft under the Code.⁴⁸² The difficulty in the treatment of the NOW instrument comes into play, however, when the notice of withdrawal period is taken into consideration.⁴⁸³ Since interest is charged on the funds in the NOW account, the moneys therein are subject to the same notice period of withdrawal as are all time deposit accounts.

In appearance, the NOW instrument is identical to a check. The holder may believe it to be a check and expect it to be treated as such. Upon taking it to the drawee bank for payment, the holder may be surprised to find that the institution exercising its right to a notice period during which neither the holder nor the drawer may legally force the institution to pay the instrument. Since, on its face, the NOW instrument appears to be payable on demand,⁴⁸⁴ mere acceptance may not be enough to satisfy a holder looking for immediate payment. The Uniform Commercial Code section 3-507⁴⁸⁵ allows an instrument to be treated as dishonored when due payment is not made. When informed that the instrument will not be paid on demand, as the face of the instrument indicates, it would seem as though the holder could choose, to treat the instrument as dishonored⁴⁸⁶ and proceed against either the drawer or a previous indorser on their contract on the instru-

⁴⁸¹ U.C.C. § 3-104(1) defines a negotiable instrument as follows:

"Any writing to be a negotiable instrument within [Article III] must

(a) be signed by the maker or drawer; and
(b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order obligation or power given by the maker or drawer except as authorized by this Article; and
(d) be payable to order or bearer."

⁴⁸² For a discussion on the character of the NOW instrument as a check or draft, see 30 BUSINESS LAWYER 151, 157-158 (Nov., 1974).

⁴⁸³ Kaplan, *supra* note 423, at 452.

⁴⁸⁴ U.C.C. § 3-108 states "Instruments payable on demand include those payable at sight or on presentment and those in which no time for payment is stated."

⁴⁸⁵ U.C.C. § 3-507(1)(a) reads as follows:

"(1) An instrument is dishonored when (a) a necessary or optional presentment is duly made and due acceptance or payment is refused or cannot be obtained within the prescribed time or in the case of bank collections the instrument is seasonably returned by the midnight deadline . . ."

⁴⁸⁶ 14 B.C. Inst. & Com. L. Rev. 493-496 (Feb. 1973).

ment.⁴⁸⁷ The payee may also have a remedy against the drawer on the underlying obligation.⁴⁸⁸

If banks would begin to enforce their right to notice prior to withdrawal, the effect on the owner of a NOW account could be catastrophic. If the holder chose to treat the instrument as dishonored at that point, the account owner could find his credit rating taking a rapid dive. He would have no right to seek redress against the bank for his loss, however. They would be acting entirely within their rights under the law and most probably the agreement signed with the account owner upon opening said account. Perhaps an alternative would be to change the face of the NOW instrument to make it clear to any holder that it is subject to a certain notice period. The words "payable on sight & 30" for example, would make it clear to the holder that a certain waiting period may be exercised prior to negotiability of the NOW instrument.⁴⁸⁹ This legend on the instrument may have drawbacks, as well. The banking public, including merchants, are accustomed to demand instruments. They may not be willing to start accepting instruments in payment for goods or services if directly made aware of and threatened with such a waiting period. However, this has not been made a problem yet, at least in New England. Seemingly, once NOW accounts were established, they were treated by both banks and customers as any other order instruments. A thorough search has found no litigation on this point as of yet. It would probably be expecting too much to hope that none would be brought now that NOW accounts are authorized nationwide.

There is also another aspect of NOW instruments that is fairly unique:

"Mention should also be made of the 'payable-through' devices which is currently in use in connection with the clearing of [some] NOW instruments. Where a thrift institution issues the NOW and where the institution itself does not make use of the Federal Reserve check-collection mechanism, the NOW will be an instrument 'payable through' a commercial bank. This simply means that NOW instrument will be routed through a commercial bank having access to the Federal Reserve clearing facilities. Section 3-120 of the Code provides that a payable instrument designates the payable-through

⁴⁸⁷ U.C.C. § 3-413(2) sets out the drawer contract as follows: "The drawer engages that upon dishonor of the draft and any necessary notice of dishonor or protest he will pay the amount of the draft to the holder or to any indorser who takes it up. The drawer may disclaim this liability by drawing without recourse." U.C.C. § 3-414(1) sets out the indorser's contract.

"Unless the indorsement otherwise specifies (as by such words as 'without recourse') every indorser engages that upon dishonor and any necessary notice of dishonor and protest he will pay the instrument according to its tenor at the time of his indorsement to the holder or to any subsequent indorser who takes it up even though the indorser who takes it up was not obligated to do so."

⁴⁸⁸ U.C.C. § 3-802(1)(b) allows the payee to proceed on the underlying obligation until the instrument is discharged.

⁴⁸⁹ This would still satisfy the "definite time" requirement of U.C.C. § 3-104(1)(c).

bank 'as a collecting bank to make the presentment but does not of itself authorize the bank to pay the instrument.' The payable-through bank's role is merely that of a collecting bank, and it must receive the drawee's authorization to pay the NOW."⁴⁹⁰

Conclusion

Although NOW accounts have been in existence in New England for quite some time, the bulk of cases in this area have dealt with the ability of depository institutions to offer NOW accounts. Now that Congress has authorized them as within the power of these institutions, this type of litigation will cease to exist. Litigation is now more likely to revolve around issues of the proper implementation and operation of NOW accounts, as well as the problems mentioned above regarding the U.C.C. interpretation of these accounts.

TITLE IV: POWERS OF THRIFT INSTITUTIONS AND MISCELLANEOUS PROVISIONS

Introduction

The Act included provisions which expanded the asset investment flexibility of Federal savings and loan associations. Changes were made in the regulations affecting insurance reserves, liquidity requirements, and ownership. Associations were authorized to issue credit cards. The Congressional intent in granting the additional powers was to "enable thrifts to become one-stop family financial centers making them more competitive and giving them the earnings they need to pay market rates to depositors."⁴⁹¹

A. Changes in Investment Authority

Investment authority for Federal savings and loan associations is categorized by the percentage of assets which the S & L can invest or loan in a given class of transaction. Classifications are related to the security of the loan or investment as well as public policy motivations which parallel tax expenditure policies. There are no limitations on the percentage of assets which may be applied to account secured loans, home mortgage loans, U.S. government securities and certain other specified secure investments.⁴⁹² Certain changes were required in this section due to the NOW account legislation and the impact of inflation on the cost of housing.

In addition to loans made on the security of savings accounts, loans

⁴⁹⁰ Kaplan, *supra* note 423 at 453-454.

⁴⁹¹ S. REP. No. 96-368, 96th Cong., 1st Sess. 13 (1979). See also 1980 House Reg. Q Hearings, *supra* note 2, at 60-61 for a discussion of the family finance center concept projections by Mr. Jay Janis, Chairman of the FHLBB, on the future role of thrift institutions.

⁴⁹² 12 U.S.C. § 1464(c) (1980).

"specifically related" to NOW accounts are now allowed.⁴⁹³ An overdraft protection instant loan associated with a NOW account might be interpreted as specifically related even though it would not be secured by an account balance. Overdraft protection loans might also be considered to be consumer loans and therefore subject collectively to the 20% limitation.⁴⁹⁴ However, regulations promulgated by the Federal Home Loan Bank Board in response to the Act provide that "If a loan that may be made under this section is also authorized to be made under another section, which may have different percentage-of-assets and other limitations or requirements, an association shall have the option of choosing under which applicable section the loan shall be made."⁴⁹⁵ The regulations specifically exclude "loans in the nature of overdraft protection" from the definition of consumer loans.⁴⁹⁶ Overdraft protection loans are now included in the broader classification of "consumer credit."⁴⁹⁷

Loans on residential real property were limited under prior law to first lien mortgages. A maximum of \$75,000 for each residence qualified for the unlimited percentage of assets category.⁴⁹⁸ The new law removes the first lien only restriction when the amount of unpaid prior mortgages is added to the loan amount for calculation purposes. Now, under this unlimited category, the loan amount, including prior mortgages, may not exceed 66-2/3% of the appraised value of unimproved real estate; 75% for real estate improved by buildings to be constructed or being constructed or improved by offsite street, water, sewers, or utilities; 90% for real estate improved by one or more buildings.⁴⁹⁹ The \$75,000 limitation is no longer applicable⁵⁰⁰ to the purchase of loans secured by liens on improved real estate which are insured under the National Housing Act⁵⁰¹ or the Servicemen's Readjustment Act of 1944.⁵⁰²

The provision for loans made for the purpose of "mobile home"

⁴⁹³ 12 U.S.C.A. § 1464(c)(1)(A) (1980). *See also* 45 Fed. Reg. 66,781 (1980) (to be codified at 12 C.F.R. § 563.43) (Regulations on NOW Accounts: Authorization for Federal Associations to Issue Accounts and Extend Overdraft Privileges to Owners).

⁴⁹⁴ 12 U.S.C. § 1464(c)(2) (1980).

⁴⁹⁵ 45 Fed. Reg. 76,104, at 76,109 (1980) (to be codified at 12 C.F.R. § 545.7-10(b)).

⁴⁹⁶ *Id.* (to be codified at 12 C.F.R. § 541.25).

⁴⁹⁷ *Id.* at 76,110 (to be codified at 12 C.F.R. § 561.38).

⁴⁹⁸ 12 U.S.C. § 1464(c)(1)(B) (Supp. III 1979). The limit was applicable to single family dwellings in the contiguous United States.

⁴⁹⁹ 12 U.S.C.A. § 1464(c)(1)(B) (1980). The FHLBB may permit a loan to value ratio greater than 90% for certain types of guaranteed loans or low income housing. *See also* 45 Fed. Reg. 76,095 (1980) (revision of Fed. S. & L. real estate lending regulations.) (to be codified at 12 C.F.R. § 563.9-7).

⁵⁰⁰ Compare 12 U.S.C. § 1464(c)(1)(I) (Supp. III 1979) with 12 U.S.C.A. § 1464(c)(1)(I) (1980).

⁵⁰¹ 12 U.S.C. § 1701 (1976).

⁵⁰² 38 U.S.C. § 1810 (1976).

financing was amended to apply to "manufactured home" financing.⁵⁰³ This was probably to fulfill the intention that loans would be used for "residential financing- not something on wheels that is going to be moved from time to time."⁵⁰⁴

An additional unlimited investment subparagraph was added which permits investments in any open-end management investment company under certain conditions.⁵⁰⁵

Investment authority on certain classes of less secure loans is limited to 20% of the assets of the association for each class. One class is comprised of first lien loans on improved commercial real estate.⁵⁰⁶ The second class for participation loans was removed and replaced by a class comprised of consumer loans and other securities. Under this class, an association "may make secured or unsecured loans for personal, family, or household purposes, and may invest in, sell, or hold commercial paper and corporate debt securities, as defined and approved by the [FHLBB]."⁵⁰⁷ This expanded authority, combined with the previously available power to make house improvement loans,⁵⁰⁸ will enable the S & L's to compete with Credit Unions for consumer related loans. The 20% allowance on these consumer loans is twice the 10% recommended by the Carter task force and provided in the initial legislation.⁵⁰⁹ The power conferred on S & L's to offer consumer loans give them a number of specific advantages:

"First, a number of studies indicate that, for S&L's with a large enough volume of consumer lending business, the net yield available from a portfolio of short-term consumer loans could be somewhat higher over the long-run than the average mortgage portfolio yield. Second, a Portfolio of short-term consumer loans promises to increase the liquidity of S&L's because of the high turnover of such consumer loans and, hence, ease somewhat the liquidity crisis that S&L's experience when savings flows fall off. Third, and most importantly consumer loan powers would produce a synergistic effect. The ability to offer a full package of family financial services, including

⁵⁰³ Compare 12 U.S.C. § 1464(c)(1)(J) (Supp. III 1979) with 12 U.S.C.A. § 1464(c)(1)(J) (1980).

⁵⁰⁴ 1980 *House Reg. Q Hearings*, *supra* note 2, at 993 (statement of Congressman Doug Barnard, Jr. of Ga.) See also statement of Will Ehrle, President of the Texas Manufactured Housing Association, 1980 *House Reg. Q Hearings*, *supra* note 2, at 952-84, 994.

⁵⁰⁵ 12 U.S.C.A. § 1464(c)(1)(Q) (1980).

⁵⁰⁶ 12 U.S.C.A. § 1464(c)(2)(A) (1980). The provision which included the excess residential real estate loan over \$75,000 within this category was removed.

⁵⁰⁷ 12 U.S.C.A. § 1464(c)(2)(B) (1980). See also 45 Fed. Reg. 76,104 (1980) (Regulations for Federal S&L's and Mutual Savings Banks; Investment in Consumer Loans, Commercial Paper and Corporate Debt. Securities.) (to be codified in scattered sections of 12 C.F.R. Parts 541 and 545).

⁵⁰⁸ 12 U.S.C.A. § 1464(c)(1)(J) (1980).

⁵⁰⁹ S. REP. NO. 96-368, 96th Cong., 1st Sess. 13 (1979).

consumer loans, should both attract new savings business to associations and help retain existing savings business."⁵¹⁰

A third category of loans and investments are limited to 5% of association assets for each class.⁵¹¹ Substantial changes were made in this category by the Act. Classes for land acquisition and development and housing facilities for the aging were removed.⁵¹² The provision for education loans was retained.⁵¹³ The provision for construction loans was modified but is presently ambiguous and requires some technical correction.⁵¹⁴

In the fourth category, (Other Loans and Investments), the limitations vary with each class specified. In the subparagraph on service corporations, the 1% limitation was changed to 3%, "except that not less than one-half of the investment permitted under this subparagraph which exceeds one per centum of assets shall be used primarily for community, inner-city, and community development purposes."⁵¹⁵

State and local government obligations which constitute prudent investments are authorized if:

- "(i) the proceeds of such obligations are to be used for rehabilitation, financing, or the construction of residential real estate, and
- (ii) the aggregate amount of all investments under this subparagraph shall not exceed the amount of the association's general reserves, surplus, and undivided profits."⁵¹⁶

Prior to the Act, these investments could only be made if the general reserves, surplus, and undivided profits exceeded 5% of withdrawable accounts, and the investments were limited by the amount of the association's general reserves, surplus, and undivided profits.⁵¹⁷ Now, the 5% standard

⁵¹⁰ 1980 House Reg. Q. Hearings, *supra* note 2, at 27-28 (statement of Jay Janis, Chairman of the FHLBB). The recommendation for secured and unsecured consumer lending was incorporated into the Act.

⁵¹¹ 12 U.S.C.A. § 1464(c)(3) (1980).

⁵¹² Compare 12 U.S.C. § 1464(c)(3)(A) (1980). (Supp. III. 1979) with 12 U.S.C.A. § 1464(c)(3) (1980).

⁵¹³ 12 U.S.C.A. § 1464(c)(3)(A) (1980).

⁵¹⁴ 12 U.S.C.A. § 1464(c)(3)(D) (1980). e.g., in the opinion of the author, the last sentence of the subparagraph should be changed to read "Investments under this subparagraph shall not be included in any percentage of assets or other percentage referred to in this subsection." comparable to clause (iii) of § 1464(c)(4)(C). Moreover, the terms of the subparagraph itself limit the investment to "not exceeding the greater of (A) the sum of its surplus, undivided profits, and reserves or (B) 5 per centum of the assets of the association . . ." The overriding 5% limitation of paragraph (3) would seem to make the above quoted phrase unnecessary.

⁵¹⁵ 12 U.S.C.A. § 1464(c)(4)(B) (1980). Service corporations as used in this subparagraph are those in which the entire capital stock is available for purchase only by S&L's of a particular state and by Federal S&L's having their home office in that state.

⁵¹⁶ 12 U.S.C.A. § 1464(c)(4)(D) (1980).

⁵¹⁷ 12 U.S.C.A. § 1464(c)(4)(D) (Supp. III 1979).

has been changed to the variable 3 to 6% insurance reserve determined by the FHLBB.⁵¹⁸

Paragraph (5) was deleted and not replaced.⁵¹⁹ The definition of "residential real property" or "residential real estate" was modified to include "property to be improved by construction of such structures."⁵²⁰

The changes in investment authority provided by the Act will enable aggressive thrift institutions to maintain existing accounts and competitively acquire new ones. In particular, the ability to offer secured and unsecured consumer loans will go far towards making neighborhood thrift institutions a one-stop "family financial center" for many depositors.

B. *Credit Cards*

A single sentence was added to the Code which could have a significant impact on the competitive balance between thrift institutions and banks. "(4) An association is authorized, subject to such regulations as the Board may prescribe, to issue credit cards, extend credit in connection therewith, and otherwise engage in or participate in credit card operations."⁵²¹ This power is especially significant because, due to high market rates, banks have been experimenting with annual service charges to compensate for the customer's free use of money when balances are paid promptly.⁵²² The S&L approach has been to charge interest from the date of purchase irrespective of the date of payment, with the line of credit secured by savings and time accounts of the credit card holder.⁵²³ Now S&L's may offer credit card plans wherein credit is extended beyond the amounts on deposit by the saver. Credit extended in connection with credit cards is included in the new definition of "consumer credit,"⁵²⁴ but specifically excluded from the new definition of "consumer loans".⁵²⁵ The supplementary information published with the final regulations by the FHLBB states:

The definition of "consumer loan" was amended to clearly indicate that credit extended in connection with credit cards and loans in

⁵¹⁸ 12 U.S.C.A. § 1464(c)(4)(D) (1980).

⁵¹⁹ 12 U.S.C.A. § 1464(c)(5) (Supp. III 1979). Paragraph (5) stated "Any associations which is converted from State-chartered institution may continue to make loans in the territory in which it made loans while operating under State charter."

⁵²⁰ 12 U.S.C.A. § 1464(c)(6)(A) (1980). This change was made necessary by changes in § 1464(c)(1)(B) which removed the \$75,000 residential loan limitation.

⁵²¹ 12 U.S.C.A. § 1464(b)(4) (1980). See also Fed. Reg. 46,338 (1980). (final rules on credit cards, etc.) (to be codified at 12 C.F.R. § 545.4-3).

⁵²² If planned major purchases are made at the start of a billing period, the bill will not arrive for about four weeks and typically an additional three weeks will be allowed for payment. If the balance is paid promptly, this results in seven weeks of free use of the money, and the process can be repeated monthly.

⁵²³ See 1980 House Reg. Q. Hearings, *supra* note 2, at 29, 75 (Statement of Jay Janis, Chairman of FHLBB, and follow-up question and answer.).

⁵²⁴ 45 Fed. Reg. 76,104, at 76,110 (1980). (to be codified at 12 C.F.R. § 561.38).

⁵²⁵ *Id.* at 76,109. (to be codified at 12 C.F.R. § 545.7-10).

the nature of overdraft protection are not "consumer loans" and are not to be counted within the 20 percent-of-assets limitation, even though they are forms of "consumer credit" and must be included in the loan classification system.⁵²⁶

This fast shuffle in the FHLBB regulations would appear to leave credit extended in connection with credit cards, unsecured by account balances, in a sort of limbo as far as percentage-of-assets limitations are concerned. FHLBB regulations also liberalized the procedures for bill paying services and traveler's convenience withdrawals.⁵²⁷

C. *Trust Powers*

The Act allowed thrift institutions to apply for the power to act as trustee, executor, administrator, guardian, or in any other fiduciary capacity exercised by state-chartered corporate fiduciaries under local laws.⁵²⁸ This new authority could fill a gap left by the unwillingness of commercial banks to promote small trust accounts for middle-income depositors. "This is because of what they perceive to be the unprofitability of this business. Given the increasing financial complexities of our economy, there is an enhanced need for financial and counselling programs and trustee services for middle-income families."⁵²⁹ "Fiduciary capacity" might include the ability to offer tax preparation services although this is not specifically dealt with in the Code or in proposed regulations.⁵³⁰

D. *Miscellaneous Provisions*

State stock S&L type institutions which existed prior to March 31, 1976 may convert to Federal stock charter.⁵³¹

Pursuant to the Act,⁵³² the FHLBB authorized investments in mutual funds to count toward the liquidity requirements where the investment portfolio of the fund was comprised of eligible assets.⁵³³ The liquidity re-

⁵²⁶ *Id.* at 76,108.

⁵²⁷ 45 Fed. Reg. 46,338, at 46,339 (1980). (to be codified at 12 C.F.R. § 545.4(b)).

⁵²⁸ 12 U.S.C.A. § 1464(n) (1980). *See also* Fed. Reg. 82,162 (1980). (final regulations on Trust Power Authorization). (to be codified at 12 C.F.R. § 550.2).

⁵²⁹ 1980 *House Reg. Q. Hearings*, *supra* note 2, at 29 (statement of Jay Janis, Chairman of the FHLBB).

⁵³⁰ *See* 45 Fed. Reg. 82,162 at 82,164 for a definition of the term "fiduciary" (to be codified at 12 C.F.R. § 550.1(c)).

⁵³¹ 12 U.S.C.A. § 1464(i) (1980). *See also* 45 Fed. Reg. 57,114 (1980). (final regulations on conversions from state stock to Federal stock charter.) (to be codified at 12 C.F.R. § 552.2-1).

⁵³² 12 U.S.C.A. § 1425a(b)(1)(D) (West Supp. 1980).

⁵³³ 45 Fed. Reg. 57,113 (1980). (Mutual Fund Investment Counting Toward Liquidity - Final Regulation). (to be codified at 12 C.F.R. § 523.10). *See also* 45 Fed. Reg. 76,104, at 76,108 (Supplementary information on Investment in Open-end Investment Companies). (to be codified at 12 C.F.R. § 545.9-4(a)).

quirement can now be satisfied also by balances maintained in a Federal Reserve bank.⁵³⁴

Provisions were made for the sale of mutual capital certificates, constituting part of the general reserves and net worth of the issuing association.⁵³⁵ The provision was included to enable mutual associations to increase the supply of funds to housing by the sale of the certificates.

TITLE V: STATE USURY LAWS

Title V of the Monetary Control and Deregulation Act of 1980⁵³⁶ deals with state usury laws. Usury laws were developed to prevent lenders from charging exorbitant or unconscionable rates of interest on the moneys they lend. They protect the consumer by placing a ceiling on the amount of interest that may be charged on loans. With the economic situation existing in the United States today, however, many states found their usury laws causing them more harm than good.

The purpose of Title V has been stated as being "to provide competitive equality among all financial institutions with respect to state usury limits."⁵³⁷ The situation leading to the undesirable effects of usury laws is a result of the dual banking system in the United States. State chartered banks had to follow the usury limits imposed upon them by state law or constitution. Federally chartered institutions, on the other hand, could charge one percent over the discount rate on commercial paper irrespective of state law.⁵³⁸ When the discount rate increases, the federally chartered banks could adjust their interest rates accordingly. Many state chartered banks, however, found themselves unable to lend money since the maximum interest rate they could charge was less than the discount rate. When the discount rate equals or exceeds statutory usury limits, the rate at which state banks could borrow from the Federal Reserve Bank by discounting their commercial paper approached the amount of interest they could charge on the loans they make. The result was disastrous because "a bank cannot reasonably borrow money at a price equal to or higher than the rate it can lend."⁵³⁹ Since state banks could not lend money, they were

"being forced to turn down favorite customers seeking loans, and, if such banks act in good conscience, to send such customers to their

⁵³⁴ 12 U.S.C.A. § 1524a(b)(1)(E) (West Supp. 1980).

⁵³⁵ 12 U.S.C.A. § 1464(b)(5)(A) (1980). *See also* 45 Fed. Reg. 82,154 (1980). (final regulations on Mutual Capital Certificates). (to be codified at 12 C.F.R. § 563.7-4).

⁵³⁶ 1980 Act, *supra* note 3.

⁵³⁷ *Usury Lending Limits: Hearings on S. 1988 before the Senate Committee on Banking, Housing, and Urban Affairs*, 96th Cong., 1st Sess. (1979) (Statement of Chairman William Proxmire). [Hereinafter referred to as *Hearings on S. 1988*].

⁵³⁸ 12 U.S.C. § 85 (1976).

⁵³⁹ *Hearings on S. 1988, supra* note 537, at 21 (Statement of John G. Heimann).

national bank competitors, where funds may be available at the higher rate of interest allowed by Federal law."⁵⁴⁰

The federally chartered banks were not enough to pick up the slack entirely, however. When market rates moved above usury ceilings, low income and high risk borrowers had great difficulty obtaining loans from commercial banks or other financial institutions subject to these ceilings.⁵⁴¹ An example of the impact of such a situation occurred in the state of Arkansas. That situation was described by Bill Clinton, that state's governor, as follows:

"The interaction of Arkansas usury provision with the tight money conditions presently prevailing affects Arkansas economy in several ways. Capital flows from our State to seek higher returns elsewhere. Lenders are unable to obtain money at competitive rates, and are forced to curtail their lending activity. Marginal borrowers, such as young people and the poor, are the first to be hit with restrictive lending policies. Housing starts and other commercial activity virtually ceases. And, as the availability of credit is restricted, a lack of money ripples through the economy of Arkansas, often forcing the State to lead the Nation into periods of economic hardship."⁵⁴²

Arkansas is not alone in experiencing such effects from usury limits. Many other states have a usury ceiling which is equal to or below the discount rates.⁵⁴³

"For example, one study shows that Tennessee's economy grew at a faster rate than the national economy except when market interest rates rose above the State usury ceilings. At that point, Tennessee's economy slowed substantially. The same study calculated that between 1974 and 1976, the annual loss in production averaged \$150 million, the annual loss of jobs averaged \$80 million, and the annual loss of assets in financial intermediaries averaged \$1.25 billion."⁵⁴⁴

As a result of these types of situations across the country, Title V was passed.⁵⁴⁵ This was done in hopes that it would help remedy these types of occurrences in the following way.

⁵⁴⁰ *Id.* at 6. (Statement of B.J. Lambert, Jr.).

⁵⁴¹ *Id.* at 20. (Statement of John G. Heimann).

⁵⁴² *Id.* at 3. (Statement of Bill Clinton). Arkansas banks were subject to a 10% usury limit at that time. This limit was constitutionally mandated.

⁵⁴³ *Id.* at 39-40. (Statement of Irvine H. Sprague). Mr. Sprague gives the following states as those having or having potential for the forementioned problems: Arkansas, Mississippi, Minnesota, Montana, South Dakota, North Dakota, New York, New Jersey, Nebraska, Iowa, South Carolina, North Carolina, Arizona, Oregon, Washington, Vermont, Ohio, West Virginia, New Mexico, Texas, Missouri, Wisconsin, and Maryland.

⁵⁴⁴ *Id.* at 20. (Statement of John G. Heimann).

⁵⁴⁵ *Id.* at 38. (Statement of Irvine H. Sprague). This legislation was seen by many as an emergency measure. Although the states themselves could remedy the condition of their economies by adjusting their usury laws, in many states this could be done only after a harmful delay. In Arkansas, for example, the usury limit was constitutional in nature making

"To compete effectively, depository institutions must be able to pay market rates for funds and obtain market rates on loans. Elimination of usury laws, coupled with diversification of thrift institution powers, will improve the earnings flexibility of thrifts and will enable thrifts, as well as other types of lenders, to be more responsive to the needs of their customers."⁵⁴⁶

In essence the provisions of Title V permanently preempt state laws in several areas. First, it preempts state usury law as to the interest rate ceilings on first mortgage loans made by depository institutions, mortgage banks, and other lenders approved by the Department of Housing and Urban Development.⁵⁴⁷ Second, it imposes a ceiling of five percent over the discount rate of the Federal Reserve Bank on all business and agricultural loans above \$25,000.⁵⁴⁸ Third, it allows all federally insured depository institutions and Federal Credit Unions to charge one percent over the discount rate set by the Federal Reserve Bank, irrespective of state ceilings.⁵⁴⁹ This is the same limit previously imposed on national banks under federal law.⁵⁵⁰ Finally, the states are given three years to override these usury laws and explicitly impose those of their own.⁵⁵¹

Throughout the hearings, concern was expressed over whether the passage of the preemption of state usury laws would be interfering with the rights of the states. This legislation was given the support of many only because the financial situation was so pressing. In addition, many states had constitutional provisions which set the usury limits and would therefore be time-consuming and difficult to change. In order to compensate for spilling over into the powers of the states, the clause was included to allow the states to override Title V. Because the economic situation in many of the states was or had potential to become unstable, many of the witnesses testifying before Congressional committees expressed a need for some type of assurance that the state usury preemption would not be held invalid by the courts.⁵⁵² As a result of this, a clause was included allowing the states to override the usury limits imposed by this Act in an attempt to pattern Title V after Public Law 93-501 which had been held valid in *Stephens*

the earliest date by which it could be changed under state law January 1981. To let the Arkansas economy continue on its course until that time would greatly amplify the ill effects already present in that state where immediate action was necessary.

⁵⁴⁶ *Id.* at 21.

⁵⁴⁷ 1980 Act, *supra* note 3, § 501(a)(1)(A) (to be noted after 12 U.S.C. § 1735f-7).

⁵⁴⁸ *Id.* at § 511(a) (to be codified at 12 U.S.C. § 86a).

⁵⁴⁹ *Id.* §§ 522-523. (to be codified at 12 U.S.C. § 1730g).

⁵⁵⁰ 12 U.S.C. § 85 (1976).

⁵⁵¹ 1980 Act, *supra* note 3, § 501(b)(2).

⁵⁵² *State Usury Ceilings: The Hearings on H.R. 2515 before the Sub-Committee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking Finance and Urban Affairs, 96th Cong., 1st Sess., 23 (April 3, 1979).*

Security Bank v. Eppivic Corporation.⁵⁵³ In that case plaintiff, Stephens Security Bank was seeking recovery on a note executed to it by defendant, Eppivic Corporation. Defendant asserted that the note was invalid as usurious under Arkansas law. Plaintiff maintained that Federal law⁵⁵⁴ applied which made the note valid. The Court accepted plaintiff's argument and held the federal legislation valid at the same time. Congress has the power under the Commerce Clause to regulate the national and monetary banking system. The Federal government also has a legitimate interest in regulating state banks whose deposits are insured by the Federal Deposit Insurance Corporation.⁵⁵⁵ That court read the clause allowing the states to override the limited federal preemption of agricultural loans as being reflective of congressional policy of permitting a state to determine its usury ceiling.⁵⁵⁶ In light of the great deal of authority the federal court attributed to Congress with regard to setting usury ceilings for banks in which there is a legitimate federal interest, it is questionable whether the absence of such clause allowing states to override the Federal Legislation would have caused the statute to become invalid. However, in an effort to allow states to continue to exercise their rights in this area, the clause was considered best included, in order to further insure the statute's limited effect and validity under the constitution.

The constitutionality of this Title was the subject of a recent case before the Supreme Court of Arkansas, *McInnis v. Cooper Communities, Inc.*⁵⁵⁷ In that case, an appeal was taken from a summary judgment in favor of Cooper Communnities, Inc. They held a note and mortgage executed by a pair of consumers on a residential lot. The interest on this note was to be twelve percent per annum which was well within the allowable range under Section 501(a) (1) of the Depository Institutions Deregulation and Monetary Control Act of 1980. Appellants claimed, however, that the note was usurious and void under Article 19, Section 13 of the Arkansas Constitution. This section places a ten percent per annum limit on such notes.⁵⁵⁸

Appellees alleged that the note was not usurious on the grounds that Section 501(b)(2)⁵⁵⁹ states that Title V overrides state usury laws ab-

⁵⁵³ 411 F. Supp. 61 (W.D. Ark. 1976); *aff'd* 553 F.2d 102 (8th Cir., 1977).

⁵⁵⁴ 12 U.S.C. § 1833a (1976).

⁵⁵⁵ 411 F. Supp. 61 at 66.

⁵⁵⁶ *Id.* at 65.

⁵⁵⁷ 271 Ark. 503, 49 Gen. L.W. 2469 (1980).

⁵⁵⁸ Article 19, § 13 of the Arkansas Constitution reads as follows: "Usury - Legal rate - All contracts for a greater rate of interest than ten percent per annum shall be void, as to principal and interest and the General Assembly shall prohibit the same by law; but when no rate of interest is agreed upon the rate shall be six per centum per annum."

⁵⁵⁹ Section 501(b)(2) of the Depository Institutions Deregulation and Monetary Control Act of 1980 reads in part:

"[The provisions concerning the usury limits under Article V] shall not apply to any loan, mortgage, credit sale, or advance made in any state after the date (on or after April 1, 1980) and certifies that the voters of such state have voted in favor of any provisions,

sent a state legislature holding to the contrary. Appellees argued that since the state of Arkansas had not taken affirmative action to override the federal usury limits set by this article, federal law, not the Arkansas Constitutional Provision, applied to the note in question.

The Arkansas court first held that "federal law must be authorized by the United States Constitution before it preempts a state constitution provision."⁵⁶⁰ Since there is no specific constitutional provision dealing with usury laws, appellee relied on the commerce clause⁵⁶¹ of the United States Constitution to uphold the legitimacy of federal usury preemption. The court rejected this argument saying:

We find nothing in any legislation involved here that pertains to the regulation of interstate commerce. The option of a state to exempt transactions within that State from pertinent provisions of the Depository Institutions Deregulation Act of 1980, is a total contradiction of any suggestion that the act is an exercise of the power of Congress to regulate interstate commerce.⁵⁶²

To which the dissent replied:

Congress will be as surprised as I to learn that there is 'nothing in any of the legislation involved here that pertains to the regulation of interstate commerce'; for regulation of money between the states seems clearly within its scope. The United States Supreme Court has many times noted the broad scope of Congress to regulate economic affairs which impact upon the several states.⁵⁶³

This decision was handed down in December. After a change in the makeup of the court in January, a petition for rehearing was granted. On February 23, the court reversed itself and held that Congress had the power under the Commerce Clause to enact Title V.⁵⁶⁴ As Arkansas was one of the states expected to resist the federal preemption of usury law, this decision will probably be very influential. Now the interesting question is whether the Arkansas legislature will take advantage of the power granted them to override this provision pursuant to section 501(b)(2) of the Act.

constitutional or otherwise, which states explicitly and by its terms that such State does not want the provisions [of the usury limit subsection] to apply with respect to loans, mortgages credit sales, and advances made in such State."

⁵⁶⁰ 271 Ark. 503, 506.

⁵⁶¹ U.S. CONST., art. I, § 8, cl. 3.

⁵⁶² 271 Ark. 503, 506.

⁵⁶³ *Id.* at 507.

⁵⁶⁴ This decision was handed down too late for a cite to be available; the information in the text came from a telephone conversation with the Clerk of the Arkansas Supreme Court (March 11, 1981).

TITLE VI: TRUTH-IN-LENDING SIMPLIFICATION AND REFORM ACT

The Truth-in-Lending Act in its original form was enacted in 1968.⁵⁶⁵ This proved to be a major piece of legislation which protected consumers by regulating the disclosure of the terms of credit transactions.⁵⁶⁶ The Act generally required creditors to disclose all material terms a consumer should be aware of, especially the cost of credit stated as an annual percentage rate.⁵⁶⁷ Through the use of the annual percentage rate, consumers were informed as to the cost of interest rates in a uniform manner. Such uniformity enabled consumers to compare and choose the lowest interest rates with the most favorable terms.⁵⁶⁸ According to a Federal Reserve Board study, consumer awareness of the true cost of interest rates increased from fifteen percent in 1969 to nearly fifty-five percent in 1977.⁵⁶⁹ In addition, the uniform manner of stating interest rates emphasized the disparity in the cost of borrowing from various types of lending institutions.⁵⁷⁰

Despite the Act's success in making consumers aware of the ramifications and cost of credit terms, Congress debated the merits of simplifying the Act of 1968. For two years (1978-1979) the Senate tried to amend the Act but the proposed changes had been attacked by the House Banking Consumer Affairs Subcommittee Chairman Annunzio (D-Ill.) and consumer advocates.⁵⁷¹ Representative Annunzio refused to allow his subcommittee to consider the Senate amendments (Senate Bill 108)⁵⁷² to the 1968 Law.⁵⁷³ In retaliation, the Senate subsequently attached Senate Bill 108 to the House banking bill 4968 later enacted as the Depository Institutions Deregulation and Monetary Control Act of 1980.⁵⁷⁴ By attaching the Senate Bill to the House Bill, Annunzio's subcommittee was circumvented because the Truth-in-Lending Amendments were sent into conference along with the banking measures.⁵⁷⁵

The conferees, one of whom was Representative Annunzio, could not

⁵⁶⁵ The Truth-in-Lending Act of 1968, Pub. L. No. 90-321, 82 Stat. 146 (1968) (current version in scattered sections of 15 U.S.C. § 1600 et. seq. (1976)).

⁵⁶⁶ *Id.*, at § 1601(a).

⁵⁶⁷ *Id.*, at § 1606.

⁵⁶⁸ S. REP. No. 96-368, 96th Cong., 1st Sess. (1979) reprinted in [1980] U.S. CONG. & AD. NEWS 849, 850.

⁵⁶⁹ *Id.*

⁵⁷⁰ *Id.*

⁵⁷¹ 38 Cong. Q. 992 (weekly rept. ed., April 12, 1980).

⁵⁷² *Truth-in-Lending Simplification and Reform Act: Hearings on S.108 and S.37 Before the Senate Committee on Banking, Housing, and Urban Affairs*, 96th Cong., 1st Sess. 133 (1979). [hereinafter *Truth-in-Lending Hearing*].

⁵⁷³ 38 Cong. Q. 992 (weekly rept. ed., April 12, 1980).

⁵⁷⁴ S. REP. No. 96-368, 96th Cong., 1st Sess. 16 (1979) reprinted in [1980] U.S. CONG. & AD. NEWS, 835, 849.

⁵⁷⁵ H.R. CONF. REP. No. 96-842, 96th Cong., 2nd Sess. 80, (1980), reprinted in [1980] U.S. CONG. & AD. NEWS 896, 908. (hereinafter HOUSE CONF. REP. 96-842).

⁵⁷⁶ 38 Cong. Q. 992 (weekly rept. ed., April 12, 1980).

reach an agreement before the end of the first session of Congress in 1979.⁵⁷⁶ On March 27, 1980, the House over Representative Annunzio's objections and accepted the conference report's suggestions.⁵⁷⁷ The Senate accepted the report March 28, 1980.⁵⁷⁸

A. *The Need for Simplification*

Senator Proxmire supported the simplification of the Truth-in-Lending Act by sponsoring the Senate Bill 108 which consisted of numerous amendments to the Act.⁵⁷⁹ Despite the Act's success, Senator Proxmire stated why simplification would be necessary:

[T]he consumer is not getting the clear simple information he needs to shop for credit. The average disclosure statement is too long and too technical. Second, the Federal Reserve Board's regulations have become so complex and voluminous many creditors, particularly small lenders, just cannot keep pace with the steady flow of new interpretations and rulings. Finally, the regulatory agencies have not adequately enforced the Act over the past decade.⁵⁸⁰

As the answer to the problem, Senator Proxmire supported the Senate Bill 108.⁵⁸¹ He contends that the consumer should receive a concise disclosure statement which is written in terms that are understandable to the average consumer. To clarify the criteria of simplification, the Federal Reserve would issue model forms of acceptable disclosure statements.⁵⁸² The distribution of model forms serve a second purpose. Creditors who have been unable to comply with the complex and frequently changing provisions of the Act prior to simplification, would now have explicit guidelines. Besides simplification, the Senate Bill proposed to enforce reprisals against creditors who had overcharged consumers on interest rates.⁵⁸³

Another avid supporter of Senate Bill 108 was Senator Garn. In a Senate hearing,⁵⁸⁴ he stated that the Federal Court case load has increased forty percent because of the prosecution of Truth-in-Lending violations which are "hypertechnical [and] supercritical violations."⁵⁸⁵ In support of his statement, Senator Garn points to a Louisiana disclosure form which was thirty-six inches long.⁵⁸⁶ This statement comprehensively disclosed all

⁵⁷⁷ 1980 Act, *supra* note 3.

⁵⁷⁸ *Id.*

⁵⁷⁹ *Truth-in-Lending Hearing, supra* note 572, at 1 (statement of Sen. Proxmire).

⁵⁸⁰ *Id.* at 1-2.

⁵⁸¹ *Id.* at 2.

⁵⁸² *Id.*

⁵⁸³ *Id.*

⁵⁸⁴ *Id.* (statement of Sen. Garn).

⁵⁸⁵ *Id.*

⁵⁸⁶ *Id.* at 3.

the terms of the transaction but if the length of the statement deters a consumer from reading it, the Act has been emasculated.

Senator Garn also attacked the ambiguous language of the Truth-in-Lending Act. He states:

I observed in one of those markup sessions [a session wherein staff attorneys determine how to interpret phrases of the Act] that if we, who were supposed to be experts including Senators and Staff members and people from the Federal Reserve and consumer groups, could not agree on what we were passing or what we meant by what we were passing, then how in the world could the average unsophisticated buyer really understand the disclosure and know what he was getting in his loans and be able to shop for the best deal?⁵⁸⁷

Thus, Senator Garn contended that simplification was needed because the legalese and complex terms were defeating the purpose of disclosure.

A strong interest group which lobbied for the passage of Senate Bill 108 was the American Bankers Association (hereinafter the ABA).⁵⁸⁸ The ABA agreed that the voluminous information required in disclosure statements overburdened the creditor and only inundated the consumer with incomprehensible information.⁵⁸⁹ To support their statement, the ABA cited a 1977 Consumer Credit survey by the Board of Governors of the Federal Reserve System which indicated that most consumers do not adequately examine the disclosure statement because it is too voluminous and complex.⁵⁹⁰

Similarly, the United States League of Savings Association, (hereinafter the League) acquiesced with the propositions of the above senators and the ABA. The main divergence had been the League's recommendations concerning civil penalties, civil liability, and the recession rights of consumers.⁵⁹¹

Senate Bill 108 was not embraced by all concerned interest groups. The Consumer Union, a consumer advocate group represented by Attorney Boardman, contended that simplification was necessary but that the Senate bill eliminated key disclosure statements.⁵⁹²

The deletions which the Consumer Union contested were that: (1). The components of the amount financed are no longer itemized,⁵⁹³ (2). Lenders

⁵⁸⁷ *Id.*

⁵⁸⁸ *Id.* at 83 (statement of David Smith Jr., American Bankers Association).

⁵⁸⁹ *Id.*

⁵⁹⁰ *Id.*

⁵⁹¹ *Id.* at 81-83.

⁵⁹² *Id.* at 12-14 (statement of Ellen Broadman, Attorney, Consumers Union).

⁵⁹³ *Id.*

no longer must disclose how they will calculate payment penalties,⁵⁹⁴ and (3). Creditors are no longer civilly liable if they do not disclose the total sale price and later charges.⁵⁹⁵ These consumer advocates maintain that the deletions would impair a consumer's ability to determine if the charges included in the loan were proper and whether the interest rate was accurate.⁵⁹⁶ These contentions have not been answered by the passage of the bill in its final form.

B. *Creating the Answer to Simplification*

The Senate Report which accompanies Senate Bill 108 states that the Senate Committee on Banking, Housing, and Urban Affairs focused on four general areas:

- (1) providing the consumer with concise, understandable information;
- (2) simplifying the requirements for compliance so creditors will not be faced with increasingly complex and frequently changing administrative interpretations;
- (3) limiting the creditors civil liability for statutory violations to material disclosures; and
- (4) increasing the level of administrative enforcement of the Truth-in-Lending Act.⁵⁹⁷

These four areas are discussed below under the Senate Report headings of: Simplifying disclosures, making compliance easier, limiting civil liability, and strengthening administrative restitution enforcement.

1. *Simplifying disclosures*

The Senate committee adopted the Federal Reserve Board's recommendation to simplify the disclosure statement.⁵⁹⁸ Simplification was to be achieved by substitution of totals for the itemization of certain figures.⁵⁹⁹ Although less information would be disclosed to the consumer, the information provided would concisely disclose all important details of the credit transaction.⁶⁰⁰ Also, descriptive phrases would be attached to numerical disclosures in order to clarify how these numbers impact upon the credit transaction.⁶⁰¹ For example, previously a numerical amount had only a name attached, such as "finance charge." Under the Committee proposal

⁵⁹⁴ *Id.*

⁵⁹⁵ *Id.*

⁵⁹⁶ *Id.*

⁵⁹⁷ S. REP. NO. 96-73, 96th Cong., 1st Sess. 3 (1979) reprinted in [1980] U.S. CONG. & AD. NEWS, 878, 879.

⁵⁹⁸ *Id.*, [1980] U.S. CODE CONG. & AD. NEWS 880.

⁵⁹⁹ *Id.*

⁶⁰⁰ *Id.*

the numerical amount and the name will include a descriptive phrase such as; "Finance charge is the amount the credit will cost the consumer annually or as a total amount."

2. Limiting Civil Liability

The creditor would be civilly liable for statutory violations in the event that the nondisclosure or mistake in stating terms would impair the consumer's ability to understand the material terms or costs of the credit transaction.⁶⁰² For example, in a closed-end transaction, the creditor would only be civilly liable for not disclosing the amount financed, the finance charge, the total amount of the payments, the annual percentage rate, the number, the amount and due dates of the payments, any security interest therein taken, and the consumer's rights of rescission if applicable.⁶⁰³ Also, the creditor would be civilly liable for a failure to disclose certain terms pertaining to an open-end transaction (also known as a revolving charge.) However, there would be no liability for a failure to state the sequence of disclosures or the identification of purchases and payments.⁶⁰⁴

The committee also proposes that the creditor would not be subjected to multiple class actions for the same violation.⁶⁰⁵ The creditor's maximum liability would be \$500,000 or one percent of the creditor's net worth, whichever is less.⁶⁰⁶

3. Making Compliance Easier

These provisions were recommended by the Committee in order to eliminate the profuse litigation concerning purely technical violations.⁶⁰⁷ The Committee tried to structure a bill which would not only protect the consumer, but the creditor who in good faith has tried to comply with the complex and ambiguous terms of the Act. An important provision is that the Federal Reserve Board will promulgate model forms and clauses for common transactions.⁶⁰⁸ Thus, a creditor can be assured of complying with the act by using a proper form. In addition, minor errors in disclosure will be tolerated.⁶⁰⁹ A creditor would be permitted an error within one-eighth percent of the actual annual percentage rate.

4. Strengthening Administrative Restitution Enforcement

One of the major concerns of the Committee was the lack of enforce-

⁶⁰² *Id.* at 7, [1980] U.S. CODE CONG. & AD. NEWS 883.

⁶⁰³ *Id.*

⁶⁰⁴ *Id.*

⁶⁰⁵ *Id.*

⁶⁰⁶ *Id.*

⁶⁰⁷ *Id.* at 6, [1980] U.S. CODE CONG. & AD. NEWS 882.

⁶⁰⁸ *Id.* at 7, [1980] U.S. CODE CONG. & AD. NEWS 883.

ment of the Truth-in-Lending Act by the federal banking agencies.⁶¹⁰ Therefore, the bill proposes that if the creditor incorrectly discloses the annual percentage rate or the finance charge, he would owe the consumer a refund.⁶¹¹ The refund would be the difference between the actual and the disclosed rate or finance charge. Thus, mandatory refunds would be an effective tool with which to enforce the provisions of the Act.

Another amendment to the Act which would strengthen its clout would be a study concerning the viability of publishing a "shopper's guide to credit."⁶¹² This guide would aid consumers in comparison shopping for credit because it would list the annual percentage rate charged by all creditors in their area.

The House conferees accepted the above Senate amendments but insisted on six changes.⁶¹³ One of the six changes which was hotly contested was whether a borrower would receive an itemization of the amount financed. The Senate bill removed this requirement, while the House amendment required this disclosure but only upon the request of the borrower.⁶¹⁴ The House conferees won on this point.⁶¹⁵

On another disputed point, the House conferees lost. The House amendment would have required *full* restitution to be made in cases where the error adversely impacts upon the creditor.⁶¹⁶ However, the Senate bill provision of *partial* restitution prevailed.⁶¹⁷

C. *The Major Provisions of the Truth-in-Lending Simplification and Reform Act*

Title VI, as passed by Congress has made major amendments and additions to the Truth-in-Lending Act. These provisions are set out below under sub-headings. Since the changes are voluminous, only the most salient provisions will be discussed.

1. General requirements of disclosure

This section is intended to simplify the Act's general disclosure requirements. In the event of multiple borrowers in a transaction not involving the right of rescission, a creditor need make disclosures only to the primary borrower.⁶¹⁸ If more than one creditor is involved, the one to whom the

⁶¹⁰ *Id.* at 8, [1980] U.S. CODE CONG. & AD. NEWS 884.

⁶¹¹ *Id.*

⁶¹² *Id.*

⁶¹³ HOUSE CONF. REP., *supra* note 575, at 80.

⁶¹⁴ *Id.*

⁶¹⁵ 38 CONG. Q. 992 (weekly rep. ed., April 12, 1980).

⁶¹⁶ *Id.*

⁶¹⁷ *Id.*

⁶¹⁸ 1980 ACT, *supra* note 3, at Title VI, § 611 (to be codified at 15 U.S.C. § 1635(A)).

obligation is payable to on its face is the creditor who has the duty to disclose the required information.⁶¹⁹

The Federal Reserve Board has the discretion to decide whether tolerances for numerical disclosures, other than the annual percentage rate, are necessary. Therefore, a creditor who makes a mistake in quoting the monthly payment will not be in violation of this Act if the Board determines that the mistake did not substantially infringe upon the consumer's rights.⁶²⁰

2. Form of disclosure

The information required by this Title, such as the terms "annual percentage rate" and "finance charge" are to be disclosed more conspicuously than the other information.⁶²¹

3. Rescission

This portion of Title VI contains several amendments regarding a consumer's right of rescission. Foremost, when a consumer uses his home as collateral for a loan, the consumer is entitled to rescind this transaction within three business days after receiving notice of his right to do so. This grace period was enacted to give the consumer time to consider the serious consequences of encumbering the title to his home. Also, this Title expands the protection to persons whose principal residence is a mobile home or trailer. In addition, the creditor must inform the consumer of the right to rescind as well as provide the consumer with forms to be used in exercising such right.⁶²²

This section also benefits the creditor. Title VI extends from ten to twenty days the period during which a creditor must refund a consumer's money and terminate a security interest following receipt of a notice of rescission. This gives the creditor an opportunity to determine whether the right of rescission is available to the consumer and whether it was properly exercised.⁶²³

The Act also provides an important provision designed to protect a consumer's right to sue for rescission while an enforcement agency is investigating a creditor for violation of this Act. This ensures that the maximum three year period (from the date of the transaction or sale of the property, whichever occurs first) for rescinding a transaction (not withstanding the fact that the creditor did not deliver forms to request rescission) does not expire before a consumer's rights are adjudicated by a regulatory agency.⁶²⁴

⁶¹⁹ *Id.* (to be codified at 15 U.S.C. § 1635(B)).

⁶²⁰ *Id.* (to be codified at 15 U.S.C. § 1535(D)).

⁶²¹ *Id.* at § 612 (to be codified at 15 U.S.C. § 1635(A)).

⁶²² *Id.*

⁶²³ *Id.* at § 612 (to be codified at 15 U.S.C. § 1635(B)).

⁶²⁴ *Id.* (to be codified at 15 U.S.C. § 1635(F)).

In addition, the Act explicitly states that a consumer who exercises his right to rescind may be awarded relief for other violations not relating to the right to rescind.⁶²⁵

Finally, the right of rescission does not apply to residential mortgage transactions⁶²⁶ transactions which refinance any unpaid accrued finance charges of an existing loan by the same creditor secured by the same property,⁶²⁷ transactions wherein the State or its agencies are creditors,⁶²⁸ or advances under a preexisting open-end credit plan which includes a security agreement and which was limited by a previous credit plan.⁶²⁹

4. Exempted Transactions

This provision exempts agricultural credit from the Act's coverage.⁶³⁰ While this eliminates a substantial portion of credit transactions from the Act's protection, Congress felt the agricultural credit is essentially commercial and therefore the protections provided by this Act are unnecessary.

5. Model Forms

The Federal Reserve Board is required to issue model forms which will protect the creditor from liability because any creditor who uses an appropriate form will be deemed to be in compliance with the Act.⁶³¹ This aids small businesses who are unable to procure legal advice in drafting forms and ensures that consumers are receiving the required information.

6. Accuracy and Dissemination of the Annual Percentage Rate.

In order to reduce the amount of litigation over technical violations of the act, Title VI provides an acceptable range for errors in a disclosure statement concerning the annual percentage rate (the interest charges). For purposes of this Act, the annual percentage rate will be accurate if the rate disclosed was within one eighth of one percent above or below the actual rate.⁶³² However, the Federal Reserve Board may allow a greater tolerance in order to simplify compliance where irregular payments are involved.⁶³³

Besides ensuring accuracy, the Federal Reserve Board has a duty to disseminate the annual percentage rate.⁶³⁴ The Board will publish, on a demonstration basis, the annual percentage rate for common types of loans

⁶²⁵ *Id.* (to be codified at 15 U.S.C. § 1635(G)).

⁶²⁶ *Id.* (to be codified at 15 U.S.C. § 1635(E)).

⁶²⁷ *Id.*

⁶²⁸ *Id.*

⁶²⁹ *Id.*

⁶³⁰ *Id.* at § 603(a), (to be codified at 15 U.S.C. § 1602(h)).

⁶³¹ *Id.* at § 605(c), (to be codified at 15 U.S.C. § 1604).

⁶³² *Id.* at § 607(c), (to be codified at 15 U.S.C. § 1606(c)).

⁶³³ *Id.*

⁶³⁴ *Id.* at § 618(a), (to be codified at 15 U.S.C. § 1646).

charged by creditors in selected metropolitan areas. These publications will act as a guide to credit in that a consumer will be better able to comparison shop for the lowest interest rates.

7. Components of the Finance Charge

The term "finance charge" was not adequately defined in the prior act. Therefore, this title eliminates the confusion over the components of a "finance charge" by stating that it includes only those charges *not* made in a comparable cash transaction.⁶³⁵

8. Civil Liability

This section is intended to restrict the scope of creditor civil liability for statutory penalties to only those disclosures which are of significant importance. A creditor may not be held liable if the creditor shows by a preponderance of the evidence that the violation was not intentional but resulted from a bona fide error such as a clerical, calculation or computer error.⁶³⁶ A creditor has no liability under this section, if within sixty days after discovering an error, he reimburses the consumer the amount charged in excess of that disclosed.⁶³⁷

Also, a creditor is not liable for merely technical violations. Liability attaches only if the nondisclosure is material.⁶³⁸ Material disclosures are defined by the Act to mean required disclosures such as the annual percentage rate, the method of determining the finance charge and the balance upon which a finance charge will be imposed, the amount to be financed, the amount of the finance charge, the total of payments, the number and amounts of payments, and the due dates or periods of payments.⁶³⁹ However, a creditor is not liable for failing to itemize the amount financed when the disclosure is requested by the borrower.⁶⁴⁰

9. Restitution

Restitution will lie when the creditor understates the annual percentage rate of finance charges. If the disclosure error resulted from a practice of violations, gross negligence, or was intended to mislead the consumer, the enforcing agency must order that the consumer pay no more than the finance charge or the annual percentage rate actually disclosed.⁶⁴¹ Notwithstanding the preceding sentence, except where the creditor has intentionally misled the consumer, no adjustment will be ordered unless the nondisclosures or

⁶³⁵ *Id.* at § 606 (to be codified at 15 U.S.C. § 1604).

⁶³⁶ *Id.* at § 615 (to be codified at 15 U.S.C. § 1635).

⁶³⁷ *Id.*

⁶³⁸ *Id.*

⁶³⁹ *Id.* at § 612 (to be codified at 15 U.S.C. § 1635).

⁶⁴⁰ *Id.* at § 615 (to be codified at 15 U.S.C. § 1635).

⁶⁴¹ *Id.* at § 608 (to be codified at 15 U.S.C. § 1607(e)(2)).

the inaccurate disclosures would have a "significantly adverse impact upon the safety or soundness of the creditor."⁶⁴² However, an agency may only require partial adjustments in compensating a consumer when a creditor's solvency would be threatened.

10. Open-End Credit Disclosure

This provision amends the prior definition of open-end credit plan in order to curb the abusive use of this plan. Merchants have been structuring a one time credit extension into a revolving charge plan (open-end credit) because the disclosure requirements are less demanding.⁶⁴³ Thus, the consumer does not receive the essential cost disclosures such as the finance charge and the total of payments if the plan is defined as open-end credit. This revision curbs such practices by requiring that creditors must reasonably contemplate repeated transactions with the consumer in the future before declaring a plan an open-end credit. As a consequence, infrequently purchased goods such as home improvements or automobiles will be classified as closed-end transactions.

Another goal of this section is to simplify the required disclosures for open-end and to aid small creditors in complying with the Act's billing requirements.⁶⁴⁴ The Act eliminates the need to state what type of security interest the consumer has acquired.⁶⁴⁵ In addition, this section relaxes the requirement that all creditors must provide a brief identification of all goods purchased on their monthly statements. A creditor with fewer than 15,000 accounts is exempt if the identification was previously furnished and the creditor treats any inquiry for documentation as if he violated the Fair Credit Billing Act.⁶⁴⁶ This exception applies to small creditors who may not have access to automatic billing equipment which would be needed to inscribe such information on his monthly statements. Granted, a consumer would receive less billing information but this would be offset by the requirements that the consumer incur no finance charge during the period of inquiry.

11. Closed-End Credit Disclosures

This section pertains to closed-end credit transactions such as home improvement or auto loans. The intent of Congress in enacting this section is to simplify the disclosure requirements of closed-end credit transactions. Such simplification would be achieved by eliminating itemization of the finance charge and the amount financed as well as a description of the type of security interest taken unless the consumer requests an itemization of

⁶⁴² *Id.*

⁶⁴³ *Id.* at § 613 (to be codified at 15 U.S.C. § 1637(b)(2)).

⁶⁴⁴ *Id.*

⁶⁴⁵ *Id.*

⁶⁴⁶ *Id.*

the amount financed.⁶⁴⁷ Less disclosure is tolerated in order to provide a disclosure statement without incomprehensible jargon. A clear, concise statement would be a more useful comparison shopping tool.

To further aid the consumer in understanding the disclosure statement, key terms such as "amount financed" and "finance charge" will be defined in the disclosure statement.⁶⁴⁸

Finally, to increase consumer awareness in closed-end credit transactions the creditor of real property must disclose the total finance charge and the total of payments in all transactions.⁶⁴⁹

D. Conclusion

While there is a considerable amount of "simplification" in the new law, not all groups affected agree that the act will solve the problems which arose from the 1968 Act and its subsequent amendments. This title seems to have been accepted, even though the House Subcommittee Chairman Annunzio and consumer advocates ardently opposed eliminating the breakdown of what a loan covers because of the strong pressure to pass the other provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980. Therefore, the provisions as enacted did not change the Act as originally proposed by consumer advocates.

TITLE VII: AMENDMENTS TO THE NATIONAL BANKING LAWS

Title VII⁶⁵⁰ of the Act contains substantive as well as housekeeping provisions affecting banks. The 6% ceiling on the annual dividend rate payable on preferred stock of banks, was removed⁶⁵¹ but preferred stockholders retain their immunity from liability for assessments to restore impairments of capital. (Under certain conditions, common stockholders of some banks may be assessed to pay in additional capital to correct a capital deficiency).⁶⁵²

Relief was given to banks holding real property in violation of existing provisions.⁶⁵³ Historically, banks have been prohibited from owning real estate ". . . to keep the capital of the banks flowing in the daily channels of commerce; to deter them from embarking in hazardous real-estate speculations; and to prevent the accumulation of large masses of such property

⁶⁴⁷ *Id.* at § 614 (to be codified at 15 U.S.C. § 1638(a)).

⁶⁴⁸ *Id.*

⁶⁴⁹ *Id.*

⁶⁵⁰ 1980 Act, *supra* note 3.

⁶⁵¹ 12 U.S.C.A. §§ 51b, 51b-1 (West Supp. 1980).

⁶⁵² 12 U.S.C. § 55 (1976). This provision is applicable to national banks, state member banks, or banks applying for membership in the Federal Reserve System *per* 12 U.S.C. § 516-1 (1976).

⁶⁵³ 12 U.S.C.A. § 29 (West Supp. 1980). *See also* 1980 House Reg. Q Hearings, *supra* note 2, at 822-23 (statement of John G. Heimann, Comptroller of the Currency). *See related testimony at 863.*

in their hands, to be held, as it were, in mortmain."⁶⁵⁴ Banks may now apply for a five year extension of the previously allowed five year holding period if they can show that a good faith effort was made to dispose of the property within the five year period and that a rushed disposal would be detrimental.

The Comptroller of the Currency was given authority to deny a bank the power to accept or retain trust accounts in cases where the trust power was unexercised for five consecutive years or where the power was unsoundly or unlawfully exercised.⁶⁵⁵ Trust companies were classified as banks, extending the restrictions on the ability of holding companies to own assets in institutions of different states.⁶⁵⁶ The Comptroller was also given authority to declare a legal holiday for national banking associations in the event of "natural calamity, riot, insurrection, war or other emergency conditions . . ."⁶⁵⁷

Previously, bank examiners under the Comptroller were under a duty to examine banks at least three times every two years.⁶⁵⁸ Under the new law, the examiners shall examine every national bank "as often as the Comptroller of the Currency shall deem necessary."⁶⁵⁹ The desirability of this provision is questionable because of the potential for abuse. Examiners may cut back on needed examinations when the budget is tight; conversely, they may pursue continuous examinations as a method of harassment. The ability to to selectively harass the banks in this way might effectively result in federal control over an individual bank's investment decisions or policies. Under the Act, examiners may also inspect the foreign operations of state banks which are members of the Federal Reserve System.⁶⁶⁰ Other miscellaneous provisions dealt with bank ownership interests including holding companies.

One significant provision dealt with the termination of the National Bank Closed Receivership Fund. A depositor or creditor of a national bank which was closed on or before Jan. 22, 1934 must apply to collect a liquidating dividend by Oct. 7, 1981.⁶⁶¹ This termination could result in a windfall to the Office of the Comptroller.

⁶⁵⁴ *National Bank v. Mathews*, 98 U.S. 621 at 626 (1878). By holding real-estate indefinitely, the bank could defer paying tax on the appreciated value.

⁶⁵⁵ 12 U.S.C.A. § 92(a) (West Supp. 1980).

⁶⁵⁶ 12 U.S.C.A. § 1842(d) (West 1980). See also 1980 House Reg. Q Hearings, *supra* note 2, at 805, 824-25 (statement of John G. Heimann, Comptroller of the Currency). See generally discussion at 875-76 concerning interstate trust operations.

⁶⁵⁷ 12 U.S.C.A. § 95(b)(1) (West Supp. 1980). "other emergency conditions" might include a run on the banks such as that which occurred in the depression era.

⁶⁵⁸ 12 U.S.C. § 481 (1976).

⁶⁵⁹ 12 U.S.C.A. § 481 (West Supp. 1980).

⁶⁶⁰ *Id.*

⁶⁶¹ Within twelve months of the last notice published by the Comptroller in the Federal Register. The last notice appeared in 45 Fed. Reg. 66,540 (1980).

TITLE VIII: REGULATORY SIMPLIFICATION

The Financial Regulation Simplification Act⁶⁶² of 1980 is a revolutionary piece of legislation. The Federal financial regulatory agencies (Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Federal Home Loan Bank Board and National Credit Union Administration Board) before promulgating regulations must determine that these regulations are needed.⁶⁶³

In order to promulgate new regulations, the regulators must meet certain criteria. First there must be an opportunity for the public and interested parties to comment on the proposed regulation. In order to help the public and interested parties comment intelligently the proposed regulations must be written in clear and simple language.⁶⁶⁴ This is a second intriguing idea in a single act. Just imagine, not only must the regulation be needed, but also understandable. What heresy! The final directive of this Act is to avoid conflicts, inconsistencies and duplications.⁶⁶⁵ The regulators are directed to follow these provisions to the maximum extent possible.

There are exceptions to the requirements of the Act.⁶⁶⁶ Two of these exceptions involve changing regulations that are already in existence; two others involve emergency situations.⁶⁶⁷ When reformulation of a proposal occurs that has already been issued for public comment it is unnecessary to reissue a regulation.⁶⁶⁸ This is also true when a change in a regulation eliminates a loophole or reduces burdens on regulated parties where delays are unnecessary if they would cause harm.⁶⁶⁹ Just what kind of harm is not stated.

There is also a provision that suspends the need for following the procedures of this Act.⁶⁷⁰ The first of these is when an emergency situation makes it impractical or unnecessary. Such circumstances could exist when only technical or clarifying amendments are needed. Another emergency situation that circumvents the need to follow the Act is when a regulation is subject to a short statutory deadline.⁶⁷¹

⁶⁶² 1980 Act, *supra* note 3, at Title VIII.

⁶⁶³ *Id.* at § 802 (to be codified at 12 U.S.C. § 3521).

⁶⁶⁴ *Id.*

⁶⁶⁵ *Id.* at § 803 (to be codified at 12 U.S.C. § 3522).

⁶⁶⁶ H.R. REP. No. 96-842, 96th Cong., 2nd Sess. 84, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 897, 912.

⁶⁶⁷ *Id.*

⁶⁶⁸ *Id.*

⁶⁶⁹ *Id.*

⁶⁷⁰ *Id.*

⁶⁷¹ *Id.*

Before a regulation is promulgated the Federal financial regulatory agencies are required to take certain facts into consideration. The regulators are directed to consider the alternatives to the regulation under consideration.⁶⁷² The costs and burdens are to be considered on both the proposed regulation and the alternatives. The regulators are directed to keep costs and burdens to a minimum in promulgating regulations.⁶⁷³ This Act should have a positive effect on the public and regulated institutions in letting them know where they stand.

TITLE IX: FOREIGN CONTROL OF UNITED STATES FINANCIAL INSTITUTIONS

The purpose of this Title was to place a moratorium of foreign acquisitions of depository institutions in the United States.⁶⁷⁴ This moratorium was to be effective until July 1, 1980 when a previously begun General Accounting Office study of the situation was to be completed.⁶⁷⁵

The intent of Title IX was not to discriminate or cause prejudice against the attempted foreign acquisitions.⁶⁷⁶ The purpose of Title IX was to give the Administration, the Federal Reserve and Congress an opportunity to review and study the situation.⁶⁷⁷

Title IX lists a number of exemptions to its provisions. The first exemption is any acquisition under \$100 million.⁶⁷⁸ Corporate reorganizations and ownership interests under foreign control that are being transferred are exempt.⁶⁷⁹ The exemption extended to applications filed on or before March 5, 1980.⁶⁸⁰ These applications were however made subject to standards that were in existence at the time.⁶⁸¹ The last exemption was for takeover of subsidiaries of a bank holding company under orders to divest by December 31, 1980.⁶⁸² This Title was not meant to affect the case one way or the other but just to give an opportunity for study of the present situation.⁶⁸³

⁶⁷² *Id.*

⁶⁷³ *Id.*

⁶⁷⁴ *Id.*

⁶⁷⁵ *Id.* The G.A.O. study concluded that the moratorium should continue until overall banking policy is established. G.A.O. REPORT No. GGD-80-66 (Aug. 26, 1980).

⁶⁷⁶ *Id.* at 85, [1980] U.S. CODE CONG. & AD. NEWS at 913.

⁶⁷⁷ *Id.*

⁶⁷⁸ *Id.* at 84; 912.

⁶⁷⁹ *Id.*

⁶⁸⁰ *Id.* at 85; 913.

⁶⁸¹ *Id.*

⁶⁸² *Id.*

⁶⁸³ *Id.*